

PART 5

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CONFIDENTIAL FIUNG

Economic Situation

USA

Future papers on USA: Relations
Internal Situation P411

PTI: May 1979

PT5: February 1990

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CLINTON ECONOMIC STIMULUS PACKAGE: HEADING FOR DEFEAT QUERY

SUMMARY

1. CLINTON STIMULUS PLAN AGAIN FAILS TO PASS SENATE. CLINTON CONTINUES TO SEEK COMPROMISE BUT ONLY CONTINUING UNEMPLOYMENT BENEFITS MAY BE SALVAGEABLE. ECONOMIC CONSEQUENCES OF FAILURE MINIMAL. BUT SERIOUS POLITICAL SET-BACK FOR THE PRESIDENT.

DETAIL

2. PRESIDENT CLINTON'S ECONOMIC STIMULUS PACKAGE IS NOW IN INTENSIVE CARE, IF NOT DEAD, FOLLOWING A FURTHER FAILURE TO OVERRIDE THE REPUBLICAN MINORITY IN THE SENATE. HAVING FAILED TO PASS THE PLAN BEFORE THE EASTER RECESS CLINTON OFFERED A COMPROMISE PROPOSAL ON 19 APRIL, SHAVING DOLLARS 4 BILLION OFF THE ORIGINAL DOLLARS 16 BILLION PACKAGE. BUT THIS TOO FAILED TO SECURE THE NECESSARY 60 VOTES IN THE SENATE ON 20 APRIL, AND FOLLOWING ANOTHER FAILURE TODAY (21 APRIL) THE DEMOCRATIC LEADERSHIP ARE CONSIDERING WHETHER TO SHELVE THE PROPOSAL. IN THE END IT MAY BE POSSIBLE TO SAVE NO MORE THAN THE DOLLARS 4 BILLION IN CONTINUING PAYMENT OF UNEMPLOYMENT BENEFITS.

3. MEANWHILE, THE OTHER HALF OF THE STIMULUS PACKAGE, THE INVESTMENT TAX CREDIT, IS ALSO IN TROUBLE. THE CHAIRMEN OF BOTH THE SENATE FINANCE COMMITTEE AND HOUSE WAYS AND MEANS COMMITTEE, (MOYNIHAN AND ROSTENKOWSKI), HAVE COME OUT PUBLICLY AGAINST THE IDEA. LEGISLATION IS NOT YET BEFORE CONGRESS. TREASURY SECRETARY BENTSEN SAID YESTERDAY HE EXPECTS IT TO BE SENT TO THE HILL WITHIN 10 DAYS.

COMMENT

4. THE LOSS OF A STIMULUS PACKAGE OF SOME DOLLARS 30 BILLION THIS

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YEAR AND NEXT WILL HAVE VIRTUALLY NO EFFECT ON THE RECOVERY OF THE DOLLARS 6 TRILLION U.S. ECONOMY. BUT THE FAILURE TO PASS THE PROPOSAL IN THE SENATE IS A MAJOR POLITICAL SET-BACK FOR CLINTON, WHO HAD BEEN RIDING HIGH ON THE RAPID AND SUCCESSFUL PASSAGE OF HIS ECONOMIC PLAN. HE HAS LOST MOMENTUM AT A CRUCIAL STAGE AS HE COMES UP TO THE 100 DAY MARK OF HIS PRESIDENCY AND JUST BEFORE HE INTRODUCES HIS HEALTHCARE REFORM PACKAGE. THE REPUBLICANS, WHO HAVE DEMONSTRATED REMARKABLE COHESION UNDER SENATOR DOLE'S LEADERSHIP, HAVE SHOWN THAT THEY ARE A FORCE TO BE RECKONED WITH.

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ADDITIONAL

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Economic Summit
summary

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cc Mrs M. M. M. (100 10)



26 March 1993

British Embassy
Washington

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PS/Chancellor
HM Treasury
Parliament Street
London SW1

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Dear Owen,

GREENSPAN ON THE US DEFICIT

I attach a copy of Alan Greenspan's testimony to the Senate Finance Committee last Wednesday. This prompted press reports - as for example in the FT of last Thursday, also attached - that Greenspan was lending support to Republican attacks on the Clinton package.

I think it is clear from the testimony that Greenspan is actually trying not to be drawn into the political debate, while making the point, as he has all along, that what Clinton has proposed is just the start of a longer term process, which will require further action on the spending side.

Essentially, his argument is that because of upward pressure on the deficit over the medium term from growth in major entitlement programmes, seeking to balance the budget by action on tax alone implies an ever increasing tax burden.

I attended a lunchtime meeting yesterday with Alice Rivlin, Deputy Director of the Office of Management and Budget. Asked about Greenspan's comments, she said then that she did not believe there was a clear preference for spending cuts rather than tax increases in the US given that the US was, by international standards, a low tax country. But she agreed that further action on spending, especially over the medium term, is necessary.

Yours,
Alex

A GIBBS
First Secretary (Economic)

FINANCIAL TIMES THURSDAY MARCH 25 1993

Greenspan cautions on tax increases

By Michael Prowse
in Washington

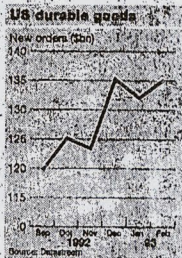
THE US Federal Reserve chairman, Mr Alan Greenspan, yesterday stepped into the political debate about deficit reduction by urging greater reliance on spending cuts than on tax increases.

The federal budget deficit was a "malignant force" that was threatening the economy's stability, Mr Greenspan said. He warned Congress not to rely too heavily in the long run on tax increases which "by their very nature restrain business activity".

He was testifying on Capitol Hill following the release of official figures showing an increase in new orders for durable goods of 22 per cent last month and 14.5 per cent in the year to February - another sign recovery is on track.

Mr Greenspan has previously argued that the Fed should stay aloof from political wrangles about the relative merits of tax increases and spending cuts - decisions which are the responsibility of Congress and the White House.

Without challenging specific elements of the administration's economic plan, Mr Greenspan yesterday appeared



to lend support to Republican critics arguing for greater spending restraint.

He said senators should recognise that "trying to wholly, or substantially, address a structural budget deficit by increasing revenues is fraught with exceptional difficulties, and is more likely to fail than to succeed".

From 1997, budget outlays were set to rise appreciably faster than the tax base. "If such trends aren't altered, stabilising the deficit-GDP ratio solely from the receipts side, not to mention reducing it, will necessarily require ever-increasing tax rates." This

would inevitably damp long-term growth prospects.

Addressing possible reforms of the budgetary process, Mr Greenspan rejected a balanced budget amendment to the constitution because it would probably prove impossible to enforce. Instead, he favoured a constitutional amendment stipulating that "all revenue and spending initiatives require super-majorities - for example, 60 per cent - to pass both houses of the Congress".

If combined with "sunset legislation" imposing explicit termination dates for spending programmes, this might help neutralise the obvious propensity of our political system toward structural deficits.

The increase in durable goods orders was larger than expected on Wall Street but mainly reflected a 10.9 per cent surge in orders for transport goods which tend to be volatile on a monthly basis. Excluding transport, orders fell slightly.

Orders for non-defence capital goods excluding aircraft - seen as the best guide to underlying civilian investment trends - rose just over 2 per cent last month and by 15 per cent in the past year.

For release on delivery
10:00 a.m. E.S.T.
March 24, 1993

Statement by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Finance

United States Senate

March 24, 1993

As I have indicated to other committees of the Congress in recent days, our burgeoning structural budget deficit, unless addressed, will increasingly threaten the stability of our economic system. Time is no longer on our side. At 5 percent of GDP, the current deficit is very large by historical standards. After declining through 1996, the current services deficit starts on an inexorable upward path again. On a cyclically adjusted or structural basis, the deficit has hovered around 3 percent of potential GDP for the last ten years, a phenomenon without precedent in our peacetime history.

I am encouraged that the President and the Congress are making serious efforts to restore a measure of balance to our fiscal affairs.

It is beguiling to contemplate the downtrend in inflation in recent years in the context of very large budget deficits and to conclude that the concerns about their adverse effects on the economy have been misplaced. Regrettably, this notion is dubious. The deficit is a corrosive force that already has begun to eat away at the foundations of our economic strength. Financing of private capital investment has been crowded out and, not surprising, the United States has experienced a lower level of net investment relative to GDP than any other of the G-7 countries in the last decade.

To some degree, the impact of the federal budget deficits over the past decade has been muted as we imported resources to help finance them. This can be seen in our large trade and current account deficits. However, we should not--

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indeed, we probably cannot--rely on foreign sources of funds indefinitely. If we do nothing, the markets will ultimately force an adjustment; by acting now to redress our internal imbalance, we can lower the risk of unpleasant stresses down the road.

I shall eschew, as I have in previous testimonies, comments on the specific elements of the deficit-reduction proposals currently under review by the Congress. I should like, nonetheless, to take the time you have made available, Mr. Chairman, to outline my views on the principles that should underlie current deliberations.

First, according to both the Office of Management and Budget and the Congressional Budget Office, deficits are likely to be held in check by relatively good economic performance over the next few years. But from 1997 on, budget outlays under existing law are projected to rise appreciably faster than the tax base. If such trends are not altered, stabilizing the deficit-to-GDP ratio solely from the receipts side, not to mention reducing it, will necessarily require ever increasing tax rates. This would surely undercut incentives for risk taking and inevitably damp the long-term growth and tax revenue potential of our economy. The gap between spending and revenues will not close under such conditions. Thus, there is no alternative to achieving much slower growth of outlays if deficit control is our objective. This implies not only the need to make cuts now, but to control the growth of future spending, so that it does not

exceed, and preferably is less than, the projected growth in the tax base.

The thought expressed by some that we can inflate our way out of the budget deficit is fanciful. Aside from its serious debilitating effects on our economic system, higher inflation, given the explicit and implicit indexing of receipts and expenditures, would not reduce the deficit. As I indicated in testimony to the Joint Economic Committee in January, there is a possibility that productivity has moved into a significantly faster long-term growth channel, which would boost real growth and tax revenues over time. But even if that turns out to be the case, short of an increase beyond anything that we can reasonably anticipate at this time, productivity, in itself, would not be enough to resolve the basic long-term imbalance in our budgetary accounts. Thus, while economic growth is necessary to contain budget deficits, it regrettably is not sufficient.

In deciding how to pare a structural budget deficit, it is important to be clear on the different roles of boosting taxes, on the one hand, and cutting spending programs on the other. All feasible taxes, by their very nature, restrain business activity. Hence, excluding so-called sin taxes and possibly environmental taxes, increases in taxes can only be justified to finance expenditures that are deemed essential. The level and composition of outlays to be financed by revenues is, in our society, a political matter, as is also the degree of progressivity and incidence of taxation. But over the long run,

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it is important to recognize that trying to wholly, or substantially, address a structural budget deficit by increasing revenues is fraught with exceptional difficulties, and is more likely to fail than succeed.

All else equal, reducing the deficit would enlarge the pool of savings available for private capital investment. But investment will not automatically occur unless there are adequate incentives for risk taking.

A greater willingness of a society to consume less of its current income should lower real interest rates and spur such investment. But if risk taking is discouraged through excessive taxation of capital or repressive regulation, high levels of investment will not emerge and the level of saving will fall as real incomes stagnate.

The process by which government deficits divert resources from private investment is part of the broader process of redirecting the allocation of real resources that inevitably accompanies the activities of the federal government. The federal government can preempt resources from the private sector or direct their usage by a number of different means, the most important of which are: (1) spending, financed by taxation; (2) spending, financed by borrowing i.e., deficit spending; (3) regulation mandating private activities such as investment in pollution control or safety equipment, which are likely to be financed through the issuance of debt; and (4) government guarantees of private borrowing.

What deficit spending and regulatory measures have in common is that the preemption of resources, directly or indirectly, is not sensitive to the rate of interest. The federal government, for example, will finance its budget deficit in full, irrespective of the interest rate it must pay to raise the funds. Borrowing with government-guaranteed debt may be interest sensitive, but the guarantees have the effect of preempting resources from those without access to riskless credit. Government spending fully financed by taxation does, of course, preempt real resources from the private sector, but the process works through channels other than through real interest rates.

Purely private activities, on the other hand, are, to a greater or lesser extent, responsive to real interest rates. The demand for housing, for example, falls off dramatically as mortgage interest rates rise. Inventory demand is clearly a function of short-term interest rates, and the level of interest rates, as it is reflected in the cost of capital, is a key element in the decision on whether to expand or modernize productive capacity. Hence, to the extent that the demand for saving exceeds its supply, interest rates will rise until sufficient excess demand is finally crowded out.

The crowded-out demand cannot, of course, be that of the federal government, directly or indirectly, because federal government demand does not respond to rising interest rates. Rather, real interest rates will rise to the point that private

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borrowing is reduced sufficiently to allow the entire requirements of the federal government, including its on- and off-budget deficits and all its collateral guarantees and mandated activities, to be met.

In these circumstances, there is no alternative to higher real interest rates diverting real resources from the private to the public sector. In the short run, nominal short-term interest rates may temporarily be held down if the Federal Reserve accommodates the excess demand for funds through a more expansionary monetary policy. But this will only produce greater inflation and, ultimately, have little, if any, effect on the allocation of real resources between the private and public sectors.

In such an environment, inflationary forces too often lead to increased risk premiums, higher real interest rates, and a higher cost of capital. This, in turn, engenders a foreshortening of the time horizon of investment decisions and a decreasing willingness to commit to the long term, a commitment that is so crucial to a modern technologically advanced economy. Structural budget deficits and excessive collateral credit preemptions are symptoms of a society overconsuming and undersaving and underinvesting.

While there is no substitute for political will in reining in outsized structural budget deficits, there are changes, I believe, that could make the budget process more effective. In particular, it is worth reconsidering sunset

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legislation, which would impose explicit termination dates on expiring programs. Expiring programs that still have merit should have no difficulty being reauthorized, but programs whose justification has become less compelling would not receive the necessary votes. Indeed, it is hard to imagine that sunset legislation would not lead to at least some improvement over the current situation, quite possibly fostering non-trivial budget savings.

It also would be useful to take a look at the current-services methodology for evaluating budget changes. A baseline estimate obviously is a necessary ingredient in the budget process that helps inform policymakers about the impact of policy proposals. However, the current services concept assumes that no further congressional, judicial, or bureaucratic actions will be taken to alter existing programs. This is quite unrealistic, but it would be of no particular significance were it not for the fact that the bias of such actions is patently toward more spending rather than less. Hence, merely owing to ongoing congressional deliberations, administrative rulings, and decisions, an add-on to the current services outlay estimates is required to get a better view of what might be termed the "expected" deficit of the future. It is not possible to know in advance which spending programs will be expanded, except that some will. In recent years, congressional current-services outlay estimates have consistently been adjusted upward in response to such technical reestimations of program costs.

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U.S. BUDGET: TAXATION OF FOREIGN CORPORATIONS

1. BEFORE THE STATE OF THE UNION ADDRESS LAST NIGHT THE U.S. SECRETARY OF THE TREASURY, LLOYD BENTSEN, ASSURED ME THAT, AS WE HAD REQUESTED, THE PRESIDENT WOULD MAKE CLEAR THAT TAXATION OF FOREIGN CORPORATIONS WOULD BE THROUGH IRS ENFORCEMENT. THERE WOULD BE NO DISCRIMINATION AGAINST FOREIGN COMPANIES. BENTSEN ADDED THAT BOTH THE U.S. AND THE EUROPEANS HAD A PROBLEM OVER TRANSFER PRICING, AT WHICH THE JAPANESE SEEMED PARTICULARLY ADEPT, AND WE NEEDED TO DISCUSS THIS TOGETHER.

2. THERE WILL BE INCREASED PENALTIES FOR EVADING THE TRANSFER PRICING RULES. THE U.S. TREASURY ESTIMATE THAT THESE SHOULD YIELD AN ADDITIONAL DOLLARS ONE BILLION ANNUALLY BY 1997/98. SOME DOLLARS SEVEN HUNDRED MILLION IS SUPPOSED TO BE RAISED OVER FIVE YEARS BY MODIFYING THE TAX CODE SO AS TO ELIMINATE THE SUPPOSED TAX PREFERENCE GIVEN TO U.S. MULTI-NATIONALS INVESTING ABROAD. THERE ARE OTHER DETAILED MEASURES WE ARE GOING TO HAVE TO EXAMINE CAREFULLY, SUCH AS THE ENHANCEMENT OF RULES AGAINST QUOTE EARNINGS STRIPPING UNQUOTE, WHICH IS SUPPOSED TO RAISE DOLLARS 579 MILLION OVER FIVE YEARS. (CHANGES TO THE RULES GOVERNING FOREIGN TAX CREDITS, PROJECTED TO YIELD 3.6 BILLION OVER FIVE YEARS, AFFECT MULTI-NATIONALS BASED IN THE U.S.)

3. ON THE TARIFF ON IMPORTS OF SPORTS UTILITY VEHICLES, BENTSEN TOLD ME THAT NO DECISION HAD YET BEEN REACHED. WE MUST CONTINUE OUR LOBBYING ON THIS SUBJECT, INCLUDING DURING THE PRIME MINISTER'S VISIT ON 24 FEBRUARY.

FCO PLEASE ADVANCE ALSO TO MR WALL, NO. 10.

RENWICK

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PRESIDENT CLINTON'S STATE OF THE UNION ADDRESS

SUMMARY

1. CLINTON MAKES IMPRESSIVE STATE OF THE UNION ADDRESS OUTLINING ECONOMIC PROGRAMME. COMBINES SHORT-TERM STIMULUS AND LONG-TERM INVESTMENT PROGRAMME. ADDRESSES BUDGET DEFICIT BY TAX INCREASES AND CUTS IN BOTH ENTITLEMENTS AND GOVERNMENT PROGRAMMES. TAXATION OF FOREIGN CORPORATIONS THROUGH NORMAL I.R.S. ENFORCEMENT. CLINTON AND CABINET NOW HAVE TO SELL THE PROGRAMME TO CONGRESS AND THE COUNTRY.

DETAIL

2. PRESIDENT CLINTON DELIVERED HIS FIRST STATE OF THE UNION ADDRESS ON 17 FEBRUARY (COPIED BY FAX TO NO 10, FCO AND TREASURY). IN THE HOUR LONG SPEECH CLINTON OUTLINED HIS ECONOMIC PROGRAMME, DIVIDED INTO 3 MAIN ELEMENTS: A SHORT-TERM FISCAL STIMULUS OF DOLLARS 30 BILLION, A LONG-TERM PUBLIC INVESTMENT PROGRAMME OF DOLLARS 160 BILLION AND A DEFICIT REDUCTION PACKAGE OF NEARLY DOLLARS 500 BILLION AIMED AT DECREASING THE DEFICIT BY DOLLARS 140 BILLION IN 1997 (FROM 5.4 PER CENT OF GDP NOW TO 2.7 PER CENT IN 1997).

3. CLINTON'S SHORT-TERM STIMULUS INCLUDES A TEMPORARY INVESTMENT TAX CREDIT, ADDITIONAL INFRASTRUCTURE SPENDING AND A SUMMER YOUTH EMPLOYMENT SCHEME. THE AIM IS TO PROVIDE 500,000 MORE JOBS. THE PACKAGE IS DESIGNED TO REMAIN WITHIN THE SPENDING CAPS SET BY THE 1990 BUDGET AGREEMENT. CLINTON'S LONG-TERM INVESTMENT PROPOSAL INCLUDES FURTHER SPENDING ON INFRASTRUCTURE, EDUCATION, TRAINING, HOUSING, THE ENVIRONMENT AND AIDS RESEARCH. IT ALSO CONTAINS A TARGETTED CAPITAL GAINS PROVISION.

4. CLINTON PROPOSES TO REDUCE THE DEFICIT BY A ROUGHLY EQUAL MIX OF NEW TAXES AND SPENDING CUTS. THE PROGRAMME ENVISAGES DOLLARS 246 BILLION IN NEW TAXES, WHICH REPUBLICANS HAVE ALREADY LABELLED THE BIGGEST TAX INCREASE IN AMERICAN HISTORY. THE MAIN ELEMENTS ON THE TAX SIDE ARE AN ENERGY TAX (ON BRITISH THERMAL UNITS OF CONSUMPTION) AND INCREASES IN PERSONAL INCOME TAX AND CORPORATION TAX. THERE IS A NEW TOP PERSONAL TAX RATE OF 36 PER CENT ON INCOMES OVER DOLLARS 115,000 AND A SURTAX OF 10 PER CENT ON INCOME OVER DOLLARS 250,000. CLINTON PUT THIS IN CONTEXT BY SAYING THAT NO-ONE EARNING UNDER DOLLARS 30,000 WOULD PAY MORE TAX AND THAT A FAMILY EARNING DOLLARS 40,000 WOULD PAY LESS THAN DOLLARS 17 A

MONTH MORE AND THIS SHOULD BE COMPENSATED FOR BY FALLING INTEREST RATES IF THE PLAN WERE SUCCESSFUL. THE CORPORATE TAX RATE GOES UP TO 36 PER CENT. THERE IS NO NEW TAXATION ON FOREIGN CORPORATIONS, AND THE AMOUNT TO BE RAISED FROM STRICTER ENFORCEMENT OF TRANSFER PRICING RULES IS REVISED DOWN TO LESS THAN DOLLARS 3 BILLION OVER 4 YEARS.

5. CLINTON PROPOSES TO SAVE DOLLARS 91 BILLION OVER 4 YEARS BY CUTS IN ENTITLEMENTS, INCLUDING CONTROLS ON HEALTHCARE COSTS AND HIGHER TAXATION ON RICHER SOCIAL SECURITY RECIPIENTS. AN ADDITIONAL DOLLARS 76 BILLION IS LOPPED OFF THE DEFENCE BUDGET OVER 4 YEARS (ABOUT WHAT WAS EXPECTED). THERE ARE SWINGEING CUTS IN GOVERNMENT PROGRAMMES FROM AGRICULTURAL SPENDING TO OVERSEAS AID. CLINTON PROPOSES A ONE YEAR FREEZE IN FEDERAL SALARIES FOLLOWED BY INCREASES LIMITED TO ONE PER CENT BELOW THE ANNUAL COST OF LIVING INCREASE. THE ADMINISTRATION WILL RELEASE DETAILED BUDGET PROPOSALS TOMORROW.

6. CLINTON ALSO REFERRED BRIEFLY TO THE OTHER PRIORITIES IN HIS DOMESTIC AGENDA INCLUDING HEALTHCARE REFORM, WELFARE REFORM, NATIONAL SERVICE, POLITICAL REFORM AND A CRIME BILL, WITHOUT MENTIONING ANY SPECIFIC NEW PROPOSALS. HE DID NOT REFER TO FOREIGN POLICY BUT DID CALL FOR SUCCESSFUL COMPLETION OF THE GATT ROUND AND THE NORTH AMERICAN FREE TRADE AGREEMENT.

7. CLINTON NOW HAS TO SELL HIS ECONOMIC PROGRAMME, AND THE PAIN IT INVOLVES, TO THE COUNTRY AND TO CONGRESS. HE AND THE ENTIRE CABINET DEPART TO DIFFERENT PARTS OF THE COUNTRY TOMORROW TO BEGIN AN INTENSIVE PUBLIC RELATIONS CAMPAIGN. CLINTON BRIEFED ROSS PEROT ON HIS PROPOSALS IN ADVANCE AND IN HIS SPEECH CALLED ON REPUBLICANS TO PUT PARTISAN DIFFERENCES BEHIND THEM AND TO WORK WITH HIM TO RESTORE THE AMERICAN ECONOMY.

RENWICK

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PRESIDENT CLINTON ADDRESS TO A JOINT SESSION OF CONGRESS

Location: The Capitol

Time: 9:11 p.m.

February 17, 1993

(AS DELIVERED)

The editor of the report is Steve Ginsburg. Tim Ahmann, Peter Ramjug, Eric Beech, Melissa Bland, Paul Schomer and Will Dunham also are available to help you. If you have questions, please call 202-898-8345. For service problems call 1-800-435-0101.

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PRESIDENT CLINTON: Thank you. thank you.

Mr. President, Mr. Speaker, members of the House and the Senate, distinguished Americans here as visitors in this chamber, as am I, it is nice to have a fresh excuse for giving a long speech.

(Laughter.)

When presidents speak to the Congress and the nation from this podium, typically they comment on the full range of challenges and opportunities that face the United States. But this is not an ordinary time. And for all the many tasks that require our attention, I believe tonight one calls on us to focus, to unite, and to act--and that is our economy. For more than anything else, our task tonight as Americans is to make our economy thrive again.

Let me begin by saying that it has been too long--at least three decades--since a president has come and challenged Americans to join him on a great national journey, not merely to consume the bounty of today but to invest for a much greater one tomorrow.

(Applause.)

Like individuals, nations must ultimately decide how they wish to conduct themselves--how they wish to be thought of by those with whom they live, and, later, how they wish to be judged by history. Like every individual man and woman, nations must decide whether they are prepared to rise to the occasions history presents them.

We have always been a people of youthful energy and daring spirit. And at this historic moment, as communism has fallen, as freedom is spreading around the world, as a global economy is taking shape before our eyes, Americans have called for change--and now it is up to those of us in this room to deliver for them.

Our nation needs a new direction. Tonight, I present to you our comprehensive plan to set our nation on that new course.

I believe we will find our new direction in the basic old values that brought us here over the last two centuries: a commitment to opportunity, to individual responsibility, to community, to work, to family, and to faith. We need to break the old habits of both political parties and say there can be no more something for nothing, and admit frankly that we are all in this together.

(Applause.)

The conditions which brought us as a nation to this point are well known: two decades of low productivity growth and stagnant

wages, persistent unemployment and underemployment; years of huge government deficits and declining investment in our future; exploding health care costs, and lack of coverage for millions of Americans; legions of poor children; educational and job training opportunities inadequate to the demands of this tough global economy. For too long we drifted without a strong sense of purpose, or responsibility or community, and our political system so often has seemed paralyzed by special-interest groups, by partisan bickering and by the sheer complexity of our problems.

I believe we can do better, because we remain the greatest nation on earth, the world's strongest economy, the world's only military superpower. If we have the vision, the will and the heart to make the changes we must, we can still enter the 21st century with possibilities our parents could not even have imagined, and enter it having secured the American dream for ourselves and future generations.

(Applause.)

I well remember 12 years ago President Reagan stood at this podium and told you and the American people that if our debt were stacked in thousand-dollar bills, the stack would reach 67 miles into space. Well, today that stack would reach 267 miles.

I tell you this not to assign blame for this problem. There is plenty of blame to go around--in both branches of the government and both parties. The time has come for the blame to end.

(Applause.)

I did not seek this office to place blame. I come here to accept responsibility, and I want you to accept responsibility with me, and, if we do right by this country, I do not care who gets the credit for it.

(Applause.)

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The Reuter Transcript Report
President Clinton/Congress
February 17, 1993
MORE Reut21:29 02-17

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BC-TEXT-CLINTON/CONGRESS-1STADD

PRESIDENT CLINTON ADDRESS TO A JOINT SESSION OF CONGRESS

Location: The Capitol

February 17, 1993

(First Add)

x x x it. (Applause.)

PRESIDENT CLINTON (continuing): The plan I offer you has four fundamental components:

First, it shifts our emphasis in public and private spending from consumption to investment, initially by jump-starting the economy in the short term and investing in our people, their jobs and their incomes over the long run.

Second, it changes the rhetoric of the past into the actions of the present, by honoring work and families in every part of our public decision-making.

Third, it substantially reduces the federal deficit, honestly and credibly, by using in the beginning the most conservative estimates of government revenues not, as the executive branch has done so often in the past, using the most optimistic ones.

(Applause.)

And, finally, it seeks to earn the trust of the American people by paying for these plans first with cuts in government waste and inefficiency: second, with cuts, not gimmicks, in government spending; and by fairness, for a change, in the way the additional burdens are borne.

(Applause.)

Tonight I want to talk with you about what government can do because I believe government must do more. But let me say first that the real engine of economic growth in this country is the private sector.

(Applause and cheers.)

And second, that each of us must be an engine of growth and change. The truth is that, as government creates more opportunity in this new and different time, we must also demand more responsibility in turn.

Our immediate priority must be to create jobs, create jobs now. Some people say, well, we're in a recovery and we don't have to do that. Well, we all hope we're in a recovery, but we're sure not creating new jobs. And there's no recovery worth its salt that doesn't put the American people back to work.

(Applause.)

To create jobs and guarantee a strong recovery, I call on Congress to enact an immediate package of jobs investments of over \$30 billion, to put people to work now, to create a half a million jobs, jobs to rebuild our highways and airports, to renovate housing, to bring new life to rural communities, and spread hope and opportunity among our nation's youth.

Especially I want to emphasize, after the events of last year in Los Angeles and the countless stories of despair in our cities and in our poor rural communities, this proposal will create almost 700,000 new summer jobs for displaced, unemployed young people alone this summer.

(Applause.)

And tonight I invite America's business leaders to join us

in this effort so that together we can provide over 1 million jobs in poor rural areas for our young people.

(Applause.)

Second, our plan looks beyond today's business cycle because our aspirations extend into the next century. The heart of this plan deals with the long term. It is an investment program designed to increase public and private investment in areas critical to our economic future and it has a deficit reduction program that will increase the savings available for the private sector to invest. will lower interest rates, will decrease the percentage of the federal budget claimed by interest payments and decrease the risk of financial market disruptions that could adversely affect our economy.

Over the long run, all this will bring us a higher rate of economic growth, improved productivity, more high-quality jobs and an improved economic competitive position in the world. In order to accomplish both increased investment and deficit reduction--something no American government has ever been called upon to do at the same time before--spending must be cut and taxes must be raised. The spending cuts I recommend were carefully thought through in a way to minimize any adverse economic impact, to capture the peace dividend for investment purposes and to switch the balance in the budget from consumption to more investment. The tax increases and the spending cuts were both designed to assure that the costs of this historic program to face and deal with our problems will be borne by those who could readily afford it the most.

Our plan is designed furthermore and perhaps in some ways most importantly to improve the health of American business through lower interest rates, more incentives to invest and better-trained workers. Because small business has created such a high percentage of all the new jobs in our nation over the last 10 or 15 years, our plan includes the boldest targeted incentives for small business in history. We propose--

(Applause.)

We propose a permanent investment tax credit for the smallest firms in this country with revenues of under \$5 million.

(Applause.)

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The Reuter Transcript Report
President Clinton/Address to the Nation (first add)
February 17, 1993
MORE Reut21:38 02-17

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BC-TEXT-CLINTON/CONGRESS--2NDADD

PRESIDENT CLINTON ADDRESS TO A JOINT SESSION OF CONGRESS

Location: The Capitol

February 17, 1993

(Second Add)

(AS DELIVERED)

x x x million. (Applause.)

PRESIDENT CLINTON (continuing): That's about 90 percent of the firms in America, employing about 40 percent of the work force, but creating a big majority of the net new jobs for more than a decade. And we propose new rewards for entrepreneurs who take new risks. We propose to give small business access to all the new technologies of our time, and we propose to attack this credit crunch which has denied small business the credit they need to flourish and prosper.

(Applause.)

With a new network of community development banks and \$1 billion to make the dream of enterprise zones real, we propose to bring new hope and new jobs to storefronts and factories from South Boston to South Texas to South Central Los Angeles.

(Applause.)

This plan invests in our roads, our bridges, our transit systems and high-speed railways and high tech information systems. And it provides the most ambitious environmental cleanup in partnership with state and local government of our time, to put people to work and to preserve the environment for our future.

(Applause.)

Standing as we are on the edge of a new century, we know that economic growth depends as never before on opening up new markets overseas and expanding the volume of world trade. And so we will insist on fair trade rules in international markets as a part of a national economic strategy to expand trade, including the successful completion of the latest round of world trade talks and the successful completion of a North American Free Trade Agreement, with appropriate safeguards for our workers and for the environment.

(Applause.)

At the same time, and I say this to you in both parties and across America tonight, all the people who are listening, it is not enough to pass a budget or even to have a trade agreement. The world is changing so fast that we must have aggressive, targeted attempts to create the high-wage jobs of the future. That's what all our competitors are doing. We must give special attention to those critical industries that are going to explode in the 21st century, but that are in trouble in America today, like aerospace.

(Applause.)

We must provide special assistance to areas and to workers displaced by cuts in the defense budget and by other unavoidable economic dislocations.

(Applause.)

And again I will say we must do this together. I pledge to you that I will do my best to see that business and labor and government work together--for a change.

(Applause.)

But all of our efforts to strengthen the economy will



fail--let me say this again; I feel so strongly about this--all of our efforts to strengthen the economy will fail unless we also take this year--not next year, not five years from now, but this year--bold steps to reform our health care system.

(Applause.)

In 1992 we spent 14 percent of our income on health care, more than 30 percent than any other country in the world, and yet we were the only advanced nation that did not provide a basic package of health care benefits to all of its citizens. Unless we change the present pattern, 30 percent of the growth in the deficit between now and the year 2000 will be in health care costs. By the year 2000 almost 20 percent of our income will be in health care. Our families will never be secure, our businesses will never be strong, and our government will never again be fully solvent--until we tackle the health care crisis. We must do it this year.

(Applause.)

The combination of the rising costs of care and the lack of care and the fear of losing care are endangering the security and the very lives of millions of our people, and they are weakening our economy every day. Reducing health care costs can liberate literally hundreds of billions of dollars for new investment and growth and jobs. Bringing health costs in line with inflation would do more for the private sector in this country than any tax cut we could give, than any spending program we could promote. Reforming health care over the long run is critically essential to reducing not only our deficit but to expanding investment in America.

(Applause.)

Later this spring, after the first lady and the many good people who are helping her all across the country complete their work, I will deliver to Congress a comprehensive plan for health care reform that finally will bring costs under control and provide security to all of our families so that no one will be denied the coverage they need but so that our economic future will not be compromised either.

(Applause.)

We'll have to root out fraud and overcharges and make sure that paperwork no longer chokes your doctor. We'll have to maintain the highest American standards and the right to choose and a system that is the world's finest for all those who can access it.

(Applause.)

But first we must make choices. We must choose to give the American people the quality they demand and deserve with a system that will not bankrupt the country or further drive more Americans into agony. Let me further say that I want to work with all of you on this. I realize this is a complicated issue, but we must address it. And I believe if there is any chance that Republicans and Democrats who disagree on taxes and spending or anything else could agree on one thing, surely we can all look at these numbers and go home and tell our people the truth. We cannot continue these spending patterns in public or private dollars for health care for less and less and less every year. We can do better.

(Applause.)

Perhaps the most fundamental change, the new direction I propose offers as its focus on the future and its investment which I seek in our children. Each day we delay really making a commitment to our children carries a dear cost. Half of the two-year olds in this country today don't receive the immunizations they need against deadly diseases. Our plan will provide them for every eligible child. And we know now that we will save ten dollars later for every one dollar we spend by eliminating preventable childhood diseases.

That's a good investment no matter how you measure it.

(Applause.)

I recommend that the Women, Infants and Children's nutrition program be expanded so that every expectant mother who needs the help gets it.

(Applause.)

Head Start, a program that prepares children for school, is a success story. We all know that it saves money, but today it just reaches barely over a third of all the eligible children. Under this plan every eligible child will be able to get a head start.

(Applause.)

This is not just the right thing to do; it is the smart thing to do. For every dollar we invest today, we'll save three tomorrow. We have to start thinking about tomorrow. I've heard that somewhere before.

(Laughter.)

We have to ask more in our schools of our students, our teachers, our principals, our parents. Yes, we must give them the resources they need to meet high standards, but we must also use the authority and the influence and the funding of the Education Department to promote strategies that really work in learning. Money alone is not enough; we have to do what really works to increase learning in our schools.

(Applause.)

We have to recognize that all of our high school graduates need some further education in order to be competitive in this global economy. So we have to establish a partnership between businesses and education and the government for apprenticeship programs in every state in this country to give our people the skills they need.

(Applause.)

Lifelong learning must benefit not just young high school graduates but workers, too, throughout their career. The average 18-year-old today will change jobs seven times in a lifetime. We have done a lot in this country on worker training in the last few years, but the system is too fractured. We must develop a unified, simplified, sensible, streamlined worker training program so that workers receive the training they need regardless of why they lost their jobs or whether they simply need to learn something new to keep them. We have got to do better on this.

(Applause.)

The Reuter Transcript Report
President Clinton/Congress (second add)
February 17, 1993
MORE Reut21:52 02-17

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BC-TEXT-CLINTON/CONGRESS-3RDADD

PRESIDENT CLINTON ADDRESS TO A JOINT SESSION OF CONGRESS

Location: The Capitol

February 17, 1993

(Third Add)

(AS DELIVERED)

x x x this. (Applause.)

PRESIDENT CLINTON (continuing): And finally, I propose a program that got a great response from the American people all across this country last year, a program of national service to make college loans available to all Americans, and to challenge them at the same time to give something back to their country. as teachers or police officers or community service workers: to give them the option to pay the loans back, but at tax time so they can't beat the bill, but to encourage them instead to pay it back by making their country stronger and making their country better and giving us the benefit of their talents.

(Applause.)

A generation ago, when President Kennedy proposed and the United States Congress embraced the Peace Corps, it defined the character of a whole generation of Americans committed to serving people around the world. In this national service program, we will provide more than twice as many slots for people before they go to college to be in national service than ever served in the Peace Corps. This program could do for this generation of members of Congress what the Land Grant College Act did and what the GI Bill did for former congressmen.

In the future, historians who got their education through the national service loan will look back on you and thank you for giving America a new lease on life if you meet this challenge.

(Applause.)

If we believe in jobs and we believe in learning, we must believe in rewarding work. If we believe in restoring the values that make America special, we must believe that there is dignity in all work, and there must be dignity for all workers. To those who care for our sick, who tend our children, who do our most difficult and tiring jobs, the new direction I propose will make this solemn, simple commitment: by expanding the refundable earned income tax credit, we will make history; we will reward the work of millions of working poor Americans by realizing the principle that if you work 40 hours a week and you've got a child in the house, you will no longer be in poverty.

(Applause.)

Later this year we offer a plan to end welfare as we know it. I have worked on this issue for the better part of a decade and I know from personal conversations with many people that no one--no one--wants to change the welfare system as badly as those who are trapped in it.

(Applause.)

I want to offer the people on welfare the education, the training, the child care, the health care they need to get back on their feet but say after two years they must get back to work, too, in private business if possible, in public service if necessary. We have to end welfare as a way of life and make it a path to

independence and dignity.

(Applause.)

Our next great goal should be strengthen our families. I compliment the Congress for passing the Family and Medical Leave Act as a good first step.

(Applause.)

But it is time to do more. This plan will give this country the toughest child support enforcement it has ever had. It has time to demand that people take responsibility for the child they bring into this world.

(Applause.)

And I ask you to help to protect our families against the violent crime which terrorizes our people and which our communities apart. We must pass a tough crime bill.

(Applause, cheers.)

I support not only the bill which didn't quite make it to the president's desk last year but also an initiative to put 100,000 more police officers on the street--

(Applause.)

--to provide boot camps for first-time, non-violent offenders, for more space for the hardened criminals in jail--

(Applause.)

--and I support an initiative to do what we can to keep guns out of the hands of criminals.

(Applause.)

I will make you this bargain: if you pass the Brady bill, I'll sure sign it.

(Applause.)

Let me say now--we should move to the harder parts.

(Applause.)

I think it is clear to every American, including every member of Congress of both parties, that the confidence of the people who pay our bills in our institutions in Washington is not high. We must restore it. We must begin again to make government work for ordinary taxpayers not simply for organized interest groups, and that beginning must start with real political reform.

(Applause.)

I am asking the United States Congress to pass a real campaign finance reform bill this year.

(Applause.)

I ask you to increase the participation of the American people by passing the motor voter bill promptly.

(Applause.)

I ask you to deal with the undue influence of special interests by passing a bill to end the tax deductions for lobbying and to act quickly to require all the people who lobby you to register as lobbyists by passing the lobbying registration bill.

(Applause.)

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The Reuter Transcript Report
President Clinton/Congress (third add)
February 17, 1993
MORE Reut21:57 02-17

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BC-TEXT-CLINTON/CONGRESS-4THADD

PRESIDENT CLINTON ADDRESS TO A JOINT SESSION OF CONGRESS

Location: The Capitol

February 17, 1993

(Fourth Add)

(AS DELIVERED)

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x x x bill. (Applause.)

PRESIDENT CLINTON (continuing): Believe me, they were cheering that last section at home. I believe lobby reform and campaign finance reform are a sure path to increased popularity for Republicans and Democrats alike because it says to the voters back home, this is your House, this is your Senate, we're your hired hands, and every penny we draw is your money.

(Applause.)

Next, to revolutionize government, we have to ensure that we live within our means, and that should start at the top and with the White House. In the last few days, I have announced a cut in the White House staff of 25 percent, saving approximately \$10 million. I have ordered administrative cuts in budgets of agencies and departments, I have cut the federal bureaucracy, or will over the next four years, by approximately 100,000 positions, for a combined savings of \$9 billion.

(Applause.)

It is time for government to demonstrate in the condition we're in that we can be as frugal as any household in America. And that's why I also want to congratulate the Congress. I noticed the announcement of the leadership today that Congress is taking similar steps to cut its costs. I think that is important, I think it will send a very clear signal to the American people.

(Applause.)

But if we really want to cut spending, we're going to have to do more, and some of it will be difficult. Tonight I call for an across-the-board freeze in federal government salaries for one year.

(Applause and cheers.)

And thereafter during this four-year period, I recommend that salaries rise at one point lower than the cost-of-living allowance normally involved in federal pay increases.

(Applause.)

Next I recommend that we make 150 specific budget cuts, as you know; and that all those who say we should cut more be as specific as I have been.

(Applause, cheers.)

Finally, let me say to my friends on both sides of the aisle, it is not enough simply to cut government. We have to rethink the whole way it works. When I became president, I was amazed at just the way the White House worked in ways that added lots of money to what taxpayers had to pay--outmoded ways that didn't take maximum advantage of technology and didn't do things that any business would have done years ago to save taxpayers' money.

So I want to bring a new spirit of innovation into every government department. I want to push education reform, as I said, not just to spend more money but to really improve learning. Some things work and some things don't. We ought to be subsidizing the things that work and discouraging the things that don't.

I'd like to use that superfund to clean up pollution for change and not just pay lawyers.

(Applause, cheers.)

In the aftermath of all the difficulties with the savings and loans, we must use federal bank regulators to protect the security and safety of our financial institutions but they should not be used to continue the credit crunch, to stop people from making sensible loans.

(Applause.)

I'd like for us to not only have welfare reform but to re-examine the whole focus of all of our programs that help people, to shift them from entitlement programs to empowerment programs. In the end, we want people not to need us anymore. I think that's important.

(Applause.)

But in the end, we have to get back to the deficit. For years, there's been a lot of talk about it but very few credible efforts to deal with it, and now I understand why, having dealt with the real numbers for four weeks. But I believe this plan does. It tackles the budget deficit seriously and over the long term. It puts in place one of the biggest deficit reductions and one of the biggest changes in federal priorities from consumption to investment in the history of this country at the same time over the next four years.

Let me say to all the people watching us tonight who will ask me these questions beginning tomorrow as I go around the country and who've asked it in the past, we're not cutting the deficit just because experts say it's the thing to do or because it has some intrinsic merit. We have to cut the deficit because the more we spend paying off the debt, the less tax dollars we have to invest in jobs, in education and the future of this country.

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The Reuter Transcript Report
President Clinton/Congress (fourth add)
February 17, 1993
MORE Reut22:05 02-17

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(REFILING TO CORRECT 5TH GRAF; BY 1997 STED BE 1997)

PRESIDENT CLINTON ADDRESS TO A JOINT SESSION OF CONGRESS

Location: The Capitol

February 17, 1993

(Fifth Add)

(AS DELIVERED)

x x x this country.

PRESIDENT CLINTON (continuing): And the more money we take out of the pool of available savings, the harder it is for people in the private sector to borrow money at affordable interest rates for a college loan for their children, for a home mortgage, or to start a new business. That's why we've got to reduce the debt, because it is crowding out other activities that we ought to be engaged in and that the American people ought to be engaged in.

(Applause.)

We cut the deficit so that our children will be able to pay a home, so that our companies can invest in the future and in retraining their workers so that our government can make the kinds of investments we need to be a stronger and smarter and safer nation.

If we don't act now, you and I might not even recognize this government 10 years from now. If we just stay with the same trends of the last four years, by the end of the decade the deficit will be \$635 billion a year, almost 80 percent of our gross domestic product, and paying interest on that debt will be the costliest government program of all. We'll still be the world's largest debtor, and when members of Congress come here they'll be devoting our 20 cents on the dollar to interest payments, more than half of the budget to health care and to other entitlements, and you'll come here and deliberate and argue over 6 or 7 cents on the dollar, no matter what America's problems are.

We will not be able to have the independence we need to chart the future that we must, and we'll be terribly dependent on foreign funds for a large portion of our investment.

This budget plan, by contrast, will by 1997 cut \$140 billion in that year alone from the deficit, a real spending cut, a real revenue increase, a real deficit reduction, using the independent numbers of the Congressional Budget Office.

(Laughter.)

Well, you can laugh, my fellow Republicans, but I'll point out that the Congressional Budget Office was normally more conservative in what was going to happen and closer to right than previous presidents have been.

(Applause.)

I did this so that we could argue about priorities with the same set of numbers; I did this so that no one could say I was estimating my way out of this difficulty; I did this because if we can agree together on the most prudent revenues we're likely to get--if the recovery stays and we do right things economically, then it'll turn out better for the American than we say. In the last 12 years, because there were differences over the revenue estimates, you and I know that both parties were given greater elbow room for irresponsibility. This is tightening the rein on the Democrats as

well as the Republicans. Let's at least argue about the same set of numbers so the American people will think we're shooting straight with them.

(Applause.)

As I said earlier, my recommendation makes more than 150 difficult reductions, to cut the federal spending by a total of \$246 billion. We're eliminating programs that are no longer needed, such as nuclear power research and development.

(Applause.)

We're slashing subsidies and canceling wasteful projects. But many of these programs were justified in their time and a lot of them were difficult for me to recommend reductions in--some really tough ones for me personally. I recommend that we reduce interest subsidies to the Rural Electric Administration. That's a difficult thing for me to recommend, but I think that I cannot exempt the things that exist in my state or in my experience if I ask you to deal with things that are difficult for you to deal with. We're going to have to have no sacred cows except the fundamental, abiding interest of the American people.

(Applause.)

I have to say that we all know our government has been just great at building programs. The time has come to show the American people that we can limit them, too, that we can not only start things, but we can actually stop things.

(Applause.)

About the defense budget, I raise a hope and a caution. As we restructure our military forces to meet the new threats of the post-Cold War world, it is true that we can responsibly reduce our defense budget. And we may all doubt what that range of reductions is, but let me say that as long as I am president, I will do everything I can to make sure that the men and women who serve under the American flag will remain the best trained, the best prepared, the best equipped fighting force in the world, and every one of you should make that solemn pledge. We still have responsibilities around the world, we are the world's only superpower, this is still a dangerous and uncertain time, and we owe it to the people in uniform to make sure that we adequately provide for the national defense and for their interests and needs.

(Applause.)

Backed by an effective national defense and a stronger economy, our nation will be prepared to lead a world challenged as it is everywhere by ethnic conflict, by the proliferation of weapons of mass destruction, by the global democratic revolution and by challenges to the health of our global environment.

I know this economic plan is ambitious, but I honestly believe it is necessary for the continued greatness of the United States. And I think it is paid for fairly, first by cutting government, then by asking the most of those who benefitted the most in the past and by asking more Americans to contribute today so that all of us can prosper tomorrow.

For the wealthiest--those earning more than \$180,000 per year--I ask you all who are listening tonight to support a raise in the top rate for federal income taxes from 31 to 36 percent. We recommend--

(Applause.)

--a ten percent surtax on incomes over \$250,000 a year

and--

(Applause.)

--we recommend closing some loopholes that some people get away without paying any tax at all.

14

(Applause.)

For businesses with taxable incomes in excess of \$10 million, we recommend a raise in the corporate rate, also to 36 percent, as well as a cut in the deduction for business entertainment expenses.

(Applause.)

Our plan seeks to attack tax subsidies that actually reward companies more for shutting their operations down here and moving them overseas than for staying here and reinvesting in America.

(Applause.)

I say that as someone who believes that American companies should be free to invest around the world and as a former governor who actively sought investment of foreign companies in my state. But the tax code should not express a preference to American companies for moving somewhere else and it does in particular cases today.

(Applause.)

We will seek to insure that through effective tax enforcement foreign corporations who do make money in America simply pay the same taxes that American companies make (sic) on the same income.

(Applause)

The Reuter Transcript Report
President Clinton/Congress (fifth add)
February 17, 1993
MORE Reut22:42 02-17

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BC-TEXT-CLINTON/CONGRESS-6THADD

PRESIDENT CLINTON ADDRESS TO A JOINT SESSION OF CONGRESS

Location: The Capitol

February 17, 1993

(Sixth Add)

(AS DELIVERED)

x x x income. (Applause)

PRESIDENT CLINTON (continuing): To middle class Americans who have paid a great deal for the last 12 years and from whom I ask a contribution tonight, I will say again, as I did on Monday, you're not going alone any more--you're certainly not going first, and you're not going to pay more for less as you have too often in the past.

I want to emphasize the facts about this plan: 98.8 percent of America's families will have no increase in their income tax rates, only 1.2 percent at the top.

(Applause.)

Let me be clear. There will also be no new cuts in benefits for Medicare.

(Applause.)

As we move toward the fourth year with the explosion in health care costs, as I said, projected to account for 50 percent of the growth of the deficit between now and the year 2000, there must be plan cuts in payments to providers--to doctors, to hospitals, to labs--as a way of controlling health care costs, but I see these only as a stopgap until we can reform the entire health care system. If you'll help me do that, we can be fair to the providers and to the consumers of health care.

(Applause.)

Let me repeat this, because I know it matters to a lot of you on both sides of the aisle. This plan does not make a recommendation for new cuts in Medicare benefits for any beneficiary. Secondly, the only change we are making in Social Security is one that has already been publicized: the plan does ask older Americans with higher incomes who do not rely solely on Social Security to get by to contribute more. This plan will not affect the 80 percent of Social Security recipients who do not pay taxes on Social Security now. Those who do not pay tax on Social Security now will not be affected by this plan.

Our plan does include a broad-based tax on energy. And I want to tell you why I selected this and why I think it's a good idea. I recommend that we adopt a Btu tax on the heat content of energy as the best way to provide us with revenue to lower the deficit, because it also combats pollution, promotes energy efficiency, promotes the independence economically of this country as well as helping to reduce the debt, and because it does not discriminate against any area. Unlike a carbon tax, it's not too hard on the coal states; unlike a gas tax, it's not too tough on people who drive a long way to work; unlike an ad valorem tax, it doesn't increase just when the price of an energy source goes up. And it is environmentally responsible: it will help us in the future as well as in the present with the deficit.

(Applause.)

Taken together, these measures will cost an American family

with an income of about \$40,000 a year less than \$17 a month. It will cost American families with incomes under \$30,000 nothing because of other programs we propose, principally those raising the earned income tax credit.

Because of our publicly stated determination to reduce the deficit, if we do these things, we will see the continuation of what's happened just since the election. Just since the election, since the secretary of the Treasury, the director of the Office of Management and Budget and others have begun to speak out publicly in favor of a tough deficit reduction plan, interest rates have continued to fall, long-term. That means that for the middle class, who will pay something more each month, if they have any credit needs or demands, their increased energy costs will be more than offset by lower interest costs for mortgages, consumer loans, credit cards. This can be a wise investment for them and their country now.

(Applause.)

I would also point out what the American people already know, and that is, because we're a big, vast country where we drive long distances, we have maintained far lower burdens on energy than any other advanced country. We will still have far lower burdens on energy than any other advanced country, and these will be spread fairly, with real attempts to make sure that no cost is imposed on families with incomes under \$30,000, and that the costs are very modest until you get into the higher income groups where the income taxes trigger in.

Now I ask all of you to consider this. Whatever you think of the tax program, whatever you think of the spending cuts, consider the costs of not changing. Remember the numbers that you all know. If we just keep on doing what we're doing, by the end of the decade, we'll have a \$650-billion-a-year deficit. If we just keep on doing what we're doing, by the end of the decade, 20 percent of our national income will go to health care every year, twice as much as any other country on the face of the globe. If we just keep on doing what we're doing, over 20 cents on the dollar will have to go to service the debt.

Unless we have the courage now to start building our future and stop borrowing from it, we're condemning ourselves to years of stagnation, interrupted by occasional recessions, to slow growth in jobs, to no more growth in incomes, to more debt, to more disappointment. Unless we change, unless we increase investment and reduce the debt to raise productivity so that we can generate both jobs and incomes, we will be condemning our children and our children's children to a lesser life than we enjoyed.

Once Americans looked forward to doubling their living standards every 25 years. At present productivity rates, it'll take a hundred years to double living standards, until our grandchildren's grandchildren are born. I say that is too long to wait.

(Applause.)

Tonight the American people know we have to change. But they're also likely to ask me tomorrow and all of you for the weeks and months ahead whether we have the fortitude to make the changes happen in the right way. They know that as soon as I leave this chamber and you go home, various interest groups will be out in force lobbying against this or that piece of this plan and that the forces of conventional wisdom will offer a thousand reasons why we well ought to do this but we just can't do it.

Our people will be watching and wondering--not to see whether you disagree with me on a particular issue but just to see whether this is going to business as usual or a real new day--whether we're all going to conduct ourselves as if we know we're working for

them. We must scale the walls of the people's skepticism, not with our words but with our deeds.

(Applause.)

After so many years of gridlock and indecision, after so many hopeful beginnings and so few promising results, the American people are going to be harsh in their judgments of all of us if we fail to seize this moment. This economic plan can't please everybody. If the package is picked apart, there will be something that will anger each of us and won't please anybody. But if it taken as a whole, it will help all of us.

So I ask you all to begin by resisting the temptation to focus only a particular spending cut you don't like or some particular investment that wasn't made--and nobody likes the tax increases--but let's just face facts. For 20 years through administrations of both parties, incomes have stalled and debt has exploded and productivity has not grown as it should. We cannot deny the reality of our condition. We have got to play the hand we were dealt and play it as best we can.

(Applause.)

My fellow Americans, the test of this plan cannot be what is in it for me; it has got to be what is in it for us.

(Applause)

If we work hard and if we work together, if we rededicate ourselves to creating jobs, to rewarding work, to strengthening our families, to reinvesting our government, we can lift our country's fortunes again. Today I ask everyone in this chamber and every American to look simply into your heart, to spark your own hopes, to fire your own imagination. There is so much good, so much possibility, so much excitement in this country now that if we act boldly and honestly, as leaders should, our legacy will be one of prosperity and progress. This must be America's new direction. Let us summon the courage to seize it.

Thank you. God bless America.

(Applause, cheers.)

END ADDRESS

The Reuter Transcript Report
President Clinton/Congress (sixth and final add)
February 17, 1993
REUTER Reut22:25 02-17

HIGHLIGHTS OF THE PRESIDENT'S ECONOMIC PROGRAM

- **Economic Stimulus**
 - \$ 30 billion stimulus package
 - Job creation: 500,000
 - Down-payment on long-term investment
 - Insurance for the economic recovery
- **Long-Term Public Investment for Economic Growth and Jobs**
 - Four-year, \$160 billion investment plan
 - Rebuild America
 - Lifelong learning
 - Rewarding work
 - Health care
 - Private-sector incentives
- **Deficit Reduction to Spur Private Investment for Growth and Jobs**
 - Largest in U.S. history
 - \$493 billion over four years, \$703 billion over five years
 - Two of every three dollars to deficit reduction
 - \$140 billion of deficit reduction in FY 1997

HOPE FOR THE FUTURE

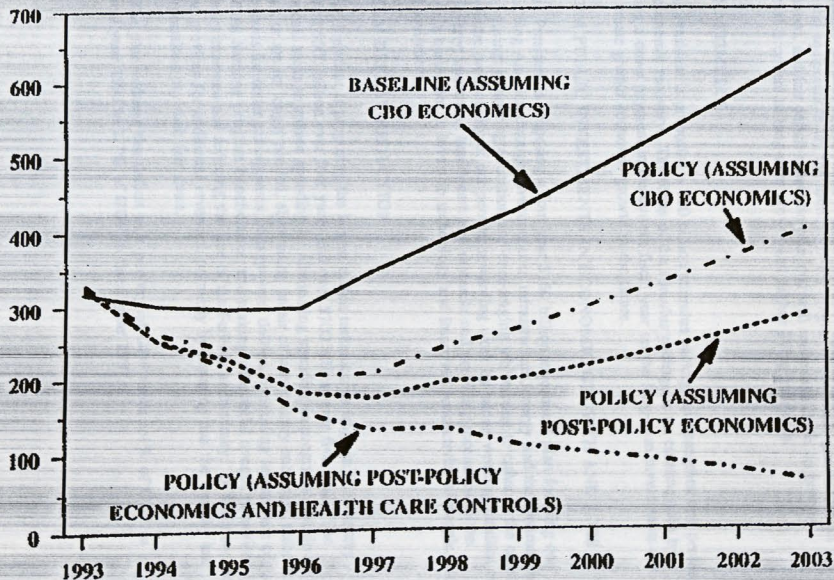
- **Jobs: 500,000 by 1994; 8,000,000 by 1996**
- **Targeted Public Investment**
 - **Infrastructure: \$48 billion**
 - **Lifelong learning: \$38 billion**
 - **Rewarding work: \$25 billion**
 - **Health care: \$26 billion**
- **Renew Private Investment: \$60 billion**
- **Restore Resources Through Deficit Reduction**
 - **\$140 billion in FY 1997**
 - **Cuts deficit as a percent of GDP in half**
- **Higher Standard of Living**

DEFICIT REDUCTION

	<u>1997</u>	<u>1994-97</u>
■ Defense	37	76
■ Nondefense	20	50
- Programs not needed		
- Trim subsidies/ fees for services		
- Management		
- Streamline		
■ Entitlements	34	76 91
- Trim subsidies/ fees for services		
- Management		
- Health care		
- Shared contribution		
■ Revenues	83	246
- Wealthy		
- Corporate		
- Energy		
- Other		

FEDERAL DEFICIT PROJECTIONS 1993 - 2003

\$ BILLIONS



HIGHLIGHTS OF THE PRESIDENT'S ECONOMIC PROGRAM

The President's economic program is a three-part plan for restoring the nation's economy, and raising the present and future incomes and living standards of America's families. It has three primary components: a stimulus program to strengthen the current recovery and provide for immediate job growth; a program of targeted investments in our people, infrastructure, technology, and equipment to lay the foundation for long-term economic growth; and a serious, balanced, and fair deficit-reduction plan that will reduce the drain on private investment that is critical to long-term growth and higher living standards.

ECONOMIC STIMULUS

- The President is proposing a \$30 billion stimulus package to strengthen and prolong the economic recovery. The focus of the stimulus package is on creating jobs by placing a down payment in the current fiscal year on the long-term investments that will create greater economic growth in the future.

LONG-TERM PUBLIC INVESTMENTS IN ECONOMIC GROWTH AND JOBS

- The President is proposing a four-year \$160 billion investment plan focusing on rebuilding America through investments in infrastructure, energy and the environment, and housing; improving education and encouraging job training to enhance the current and future productivity of our people; rewarding work by taking working families out of poverty; improving health care and research; and providing incentives to the nation's businesses to invest in technology and improved productivity of people, plants and equipment.

LONG-TERM DEFICIT REDUCTION

- The President is proposing the largest deficit reduction package in U.S. history - almost \$500 billion over four years and over \$700 billion over five years. The proposal seeks to reduce spending by eliminating spending in programs that do not work or are no longer needed, eliminating unfair or unnecessary subsidies, reforming programs for better management of taxpayers' dollars, controlling health care costs without harming program beneficiaries, and making substantial overall reductions in agency expenses and reducing the size of the Federal bureaucracy. In addition, the plan provides for additional revenues, primarily by ensuring that the wealthy and corporations pay their fair share.
- The plan reduces the deficit as a percent of GDP from 5.4% of GDP in fiscal year 1993 to 2.7% of GDP in fiscal year 1997.

STIMULUS

To sustain and strengthen the recovery and create additional jobs now, the President has proposed an economic stimulus plan totalling \$30 billion to be passed by the Congress on an expedited schedule.

- This plan will produce over 500,000 full and part-year jobs through investments in highways, summer youth employment, community development, natural resource protection, summer Head Start, the WIC program, youth employment, veterans facility upgrading and energy conservation.
- Following are some major components of the stimulus proposal:
 - \$3.0 billion in highway investments
 - \$2.5 billion in Community Development Block Grants
 - \$845 million in wastewater clean-up initiatives
 - \$1.0 billion in summer youth employment and training
 - a temporary incremental investment tax credit
- The spending portion of the stimulus package will be within the overall discretionary spending totals for fiscal year 1993 agreed to in the 1990 Budget Agreement.

LONG-TERM INVESTMENTS

The long-term investments proposed by the President address the investment deficit -- both public and private -- that has shortchanged our children, workers, businesses, and communities. They are targeted to areas that have been starved for resources yet are critical to long-term economic growth and rising standards of living. Following are highlights of the additional investments proposed through fiscal year 1997:

REBUILD AMERICA - \$18.6 billion by FY 97, \$48 billion over four years, for initiatives to restore the nation's infrastructure, environment, housing stock, and technology base.

- **Transportation** - \$3.0 billion in FY 97, \$8.4 billion over four years; full funding of 1991 highway bill; investments in mass transit, high speed rail, airport improvements
- **Technology** - \$6.1 billion in FY 97, \$17.0 billion over four years; National Science Foundation, science, engineering and technology grants, high performance computing, extension of the research and development tax credit
- **Environment** - \$3.5 billion in FY 97, \$8.0 billion over four years; \$4.5 billion for clean water and increases for environmental technology, weatherization grants, forestry research, and natural resource protection
- **Energy** - over \$1.3 billion in FY 97, \$3.0 billion over four years; energy conservation and renewable energy programs, fusion research and more energy efficient Federal buildings.
- **Housing and Community Development** - \$3.1 billion in FY 97, \$9.6 billion over four years; Community Development Block Grants, enterprise zones, assisted housing, extension of low-income housing tax credit
- **Rural Development** - \$620 million in FY 97, \$1.5 billion over four years; rural water and waste loans and grants, community and business development for rural areas

LIFELONG LEARNING - \$15.7 billion in FY 97, \$37.8 Billion over four years for programs to educate and train our people from early childhood through adulthood. Included are defense conversion measures. The following increases are for fiscal year 1997:

- **National Service** - \$3.0 billion
- **WIC**: full funding by 1996 - \$984 million
- **Head Start**: full funding by fiscal year 1999 - \$3.7 billion
- **Education reform and initiatives** - \$3.2 billion
- **Worker training** - \$4.1 billion
- **Youth Apprenticeship** - \$500 million
- **Parenting and Family Support** - \$495 million

(MORE)

INVESTMENTS

2-2-2-2

REWARDING WORK - \$7.5 billion in FY 97, \$25 billion over four years to remove disincentives for work, protect those who are temporarily unemployed and secure safer communities.

- Expand Earned Income Tax Credit - \$6.6 billion
- Extension of Unemployment Compensation
- Crime initiative - \$837 million

HEALTH CARE - \$9.4 billion in FY 97, \$26 billion over four years for improving public health programs to help families and make our workers more productive, including:

- AIDS, women's health, and other public health initiatives - \$3.4 billion
- AIDS - Ryan White Act full funding - \$394 million
- Drug and substance abuse prevention and treatment - \$800 million
- Nutrition assistance and USDA food safety initiative - \$102 million
- Improving Social Security disability insurance processing - \$200 million
- VA Medical Care - \$800 million

PRIVATE SECTOR INCENTIVES. \$3.0 billion in FY 97, \$24 billion over four years in carefully targeted incentives and initiatives to encourage investments that provide technological gains and improved productivity of plants, equipment, and people, including:

- targeted capital gains provision
- alternative minimum tax relief for corporations
- permanent small business investment tax credit

DEFICIT REDUCTION

It is critical that we reduce long-term budget deficits in order to make room for greater private investment in the economy. This economic plan proposes the largest deficit reduction effort in U.S. history - larger than the 1990 Budget Agreement.

- The four year deficit reduction plan totals \$496 billion
- In FY 1997 the deficit is reduced by \$140 billion
- Federal spending is cut by \$253 billion over four years, including:
 - Defense savings of \$76 billion
 - Non-defense discretionary spending cuts of \$54 billion
 - Entitlement reductions of \$91 billion
- Revenues are increased by \$242 billion over four years

A. Programs That Don't Work or Are No Longer Needed. Making government work for the next century means ending funding in programs that don't work and updating policies and programs that were designed to meet the needs of an earlier era. Savings here include:

- Consolidating overseas broadcasting programs
- Terminating obsolete commissions
- Terminating State Justice Institute

B. Eliminating Subsidies and Wasteful Programs, Charging Fees for Government Services. The nation can no longer afford subsidies and giveaways to those who don't need them, and we must assure that the taxpayer is fairly compensated for services or resources provided by government. Savings here include:

- Auctioning spectrum for new communications services to end windfalls
- Reducing export promotion support for large companies
- New or increased user fees for SEC registration and grain inspection
- Extending fees for DOE environmental clean-up costs to foreign customers

C. Managing Government for Cost-Effectiveness and Results. Making our government more effective and efficient means abandoning structures and practices that impede flexibility, waste resources, and frustrate service delivery. Savings here include:

- White House and government-wide administrative and employee reductions
- Streamlining USDA offices
- Strengthening child support enforcement mechanisms
- Phasing out Impact Aid "b" payments

(MORE)

DEFICIT REDUCTION

2-2-2-2

D. Controlling Health Care Costs. Systemwide reform is a top priority, but some additional short-term savings proposals which do not harm beneficiaries are necessary as a down-payment on controlling health care costs. Savings here include:

- Setting laboratory and durable medical equipment rates at market levels
- Capping excessive physician and hospital reimbursement

E. Shared Contribution. For deficit reduction to succeed, all groups must contribute. Only if there is a sharing of the load can the entire country be sure that everyone is participating. Savings here include:

- Taxing more of Social Security benefits for upper-income recipients, affecting 22% of beneficiaries
- Ending lump-sum benefits for Federal retirees

Appendix

TABLE 1. DEFENSE DISCRETIONARY PROPOSALS

(in billions of dollars)

	1993	1994	1995	1996	1997	1998
Current OBRA Baseline:						
Budget Authority	274.3	288.0	296.4	304.5	312.9	321.5
Outlays	294.3	289.6	293.8	299.8	306.5	313.8
Change from OBRA to Bush Adjusted:						
Budget Authority		-12.5	-18.4	-25.2	-28.3	-28.1
Outlays		-5.3	-8.5	-15.2	-20.0	-24.8
Current Bush Adjusted Baseline:						
Budget Authority		275.5	278.0	278.3	284.6	293.4
Outlays		284.4	284.3	284.6	286.5	289.0
Proposed Policy Changes:						
Budget Authority		-11.8	-15.2	-24.5	-36.2	-39.2
Outlays		-6.7	-11.7	-19.7	-37.4	-36.3
Proposed Defense Discretionary:						
Budget Authority	274.3	263.7	262.8	253.8	248.4	254.2
Outlays	294.3	277.7	272.6	264.9	249.1	252.7

Appendix

TABLE 2. NON-DEFENSE DISCRETIONARY PROGRAM SAVINGS

(Outlays in millions of dollars)

	1994	1995	1996	1997	1998	Total
PROGRAMS THAT DON'T WORK OR ARE NO LONGER NEEDED						
Commerce:						
Eliminate Trade Adjustment Assistance for firms.....	-1	-5	-10	-14	-14	-30
Reduction in Export Administration workload.....	-6	-7	-7	-7	-7	-27
Health and Human Services:						
Fund priority health professions curriculum assistance grants.....	-14	-21	-25	-27	-29	-87
State:						
Eliminate Russia/Eurasia research.....	-1	-8	-10	-10	-11	-29
Environmental Protection Agency:						
Completion of wastewater treatment grants authorization (except NAFTA).....	-100	-624	-1,424	-1,947	-2,207	-4,104
Appalachian Regional Commission:						
Freeze Appalachian Regional Commission.....	-1	-2	-6	-11	-12	-20
Community Investment Program:						
Reforms in light of new crime initiative.....		-211	-411	-532	-650	-1,154
State Justice Institute:						
Terminate State Justice Institute.....	-3	-15	-16	-17	-17	-51
Tennessee Valley Authority:						
Terminate TVA fertilizer and community development.....	-42	-46	-60	-60	-62	-188
Multi-Agency:						
Eliminate unnecessary nuclear reactor R&D.....	-97	-198	-257	-268	-279	-820
Terminate commissions.....	-9	-10	-11	-11	-11	-41
Subtotal, Programs That Don't Work or are No Longer Needed.....	-283	-1,147	-2,227	-2,894	-3,189	-6,551
ELIMINATING SUBSIDIES: CHARGING FEES FOR GOVERNMENT SERVICES						
Agriculture:						
Reduce Rural Electrification Administration 5-percent loan subsidies.....	-27	-77	-120	-150	-171	-374
Expand certain agriculture user fees.....	-14	-14	-15	-16	-16	-59
Eliminate Cooperative State Research Service (CSRS) earmarked research grants.....	-4	-18	-32	-42	-46	-96
Eliminate CSRS earmarked facilities construction.....	-3	-7	-32	-44	-60	-86
Eliminate earmarked special extension grants.....	-13	-13	-14	-14	-15	-54
Eliminate Agricultural Research Service earmarked facilities construction.....	-1	-6	-7	-10	-10	-24
Meat/Poultry fees: Reimbursement for overtime.....	-104	-104	-104	-104	-104	-416
Commerce:						
Terminate NOAA demonstration projects.....	-30	-55	-65	-70	-73	-220
Corps of Engineers:						
Reduce construction funding for lower priority water projects.....	-85	-70	-30	-60	-15	-235
Energy:						
Assess foreign customers decommissioning and decontamination fee (receipts).....	-10	-10	-11	-11	-12	-42
Health and Human Services:						
Increase FDA user fees.....	-167	-230	-265	-336	-367	-1,018

Appendix

TABLE 2. NON-DEFENSE DISCRETIONARY PROGRAM SAVINGS—Continued

(Outlays in millions of dollars)

	1994	1995	1996	1997	1998	Total
Housing and Urban Development:						
Eliminate special purpose grants	-5	-73	-209	-278	-288	-565
Interior:						
Reduce construction funding for lower priority water projects	-18	-40	-63	-42	-23	-163
Transportation:						
Eliminate low priority Transportation programs and projects	-129	-337	-438	-428	-417	-1,332
Treasury:						
Establish a Bureau of Alcohol, Tobacco, and Firearms user fee	-5	-5	-5	-5	-5	-20
Small Business Administration:						
Eliminate SBA earmarked grants	-44	-71	-90	-110	-116	-315
Securities and Exchange Commission:						
Increase SEC Registration Fees	-47	-80	-82	-84	-96	-290
Subtotal, Eliminating Subsidies: Charging Fees for Government Services	-705	-1,180	-1,572	-1,764	-1,814	-5,222
MANAGING GOVERNMENT FOR COST-EFFECTIVENESS AND RESULTS						
Agriculture:						
Reduce Enterprise for the Americas debt forgiveness (P.L. 480)	-5	-17	-20	-35	-38	-79
Reduce development-oriented foreign food aid	-30	-63	-72	-81	-90	-246
Phase out below-cost timber sales (Forest Service)	-46	-89	-83	-85	-86	-274
Implement one new Farm Service Organization	-65	-139	-219	-307	-403	-730
Reform crop insurance through area-yield	-105	-110	-165	-171	-177	-551
Reduce Economic Research Service programs	-12	-16	-16	-17	-18	-61
Reduce Foreign Agriculture Service programs	-5	-10	-10	-10	-10	-35
Reduce direct ACIF farm loans 25%; replace with guarantees	-3	-8	-10	-10	-11	-31
Education:						
Reform carmou-based aid	-20	-198	-229	-275	-312	-732
Phase out impact aid "b"	-30	-86	-134	-145	-149	-404
Energy:						
Stretchout Superconducting Super Collider	108					108
Implement uranium enrichment initiative	-241	-274	-374	-386	-340	-1,275
Reduce Strategic Petroleum Reserve #1 by one-third	-55	-58	-22	37	39	-98
Housing and Urban Development:						
Eliminate public housing new construction amendments			-7	-35	-58	-43
Modify fees Federal housing	-80	-85	-136	-193	-204	-454
Reforming low-income housing preservation	-5	-15	-37	-58	-80	-115
Consolidate several HUD housing programs into HOME	-1	29	-56	-150	-474	-178
Justice:						
Reduce prison construction	-7	-40	-103	-181	-249	-331
Transportation:						
Maintain level Federal Aviation Administration (Operations)	-55	-62	-62	-62	-62	-241
Adjust Coast Guard for military pay	-29	-53	-69	-85	-93	-237
Veterans Affairs:						
Reform major construction	-7	-46	-95	-134	-152	-282
Improve management of VA hospitals	-100	-200	-300	-400	-500	-1000
Environmental Protection Agency:						
Increase private sector Superfund financing	-31	-73	-95	-109	-118	-306

Appendix

TABLE 2. NON-DEFENSE DISCRETIONARY PROGRAM SAVINGS—Continued

(Outlays in millions of dollars)

	1994	1995	1996	1997	1998	Total
National Aeronautics and Space Administration:						
Redesign Space Station and Invest in new technology.....	203	662	625	636	510	2126
Small Business Administration:						
Reduce 7(a) business loan subsidies.....	-58	-113	-116	-118	-121	-406
Board for International Broadcasting:						
Consolidate overseas broadcasting.....	-60	-59	-281	-244	-250	-644
Executive Office of the President:						
Cut White House and Office of National Drug Control Policy staff.....	-30	-32	-37	-40	-43	-129
Funds Appropriated to the President:						
Re-orient AID programs and reduce spending.....	-7	-84	-152	-257	-341	-500
Phase out defense acquisition fund.....	-23	-62	-128	-133	-86	-386
Reduce International Security Assistance.....	-84	-264	-804	-731	-943	-1582
Reduce Enterprise for the Americas debt forgiveness (AID).....	-8	-20	-34	-45	-54	-107
Export Import Bank of the United States:						
Reduce Export Import Bank credits.....	-3	-6	-39	-105	-148	-153
U.S. Information Agency:						
Russian Far East Technical Assistance Center.....	-2	-2	-2	-2	-2	-6
Terminate funding for North-South Center.....	-4	-4	-4	-4	-4	-16
Multi-Agency:						
Freeze other foreign assistance programs.....	-6	-14	-75	-95	-111	-130
Maintain current program level for programs in small agencies.....	-12	-30	-60	-92	-124	-194
No Federal Pay Raise CY94; ECI-Based Raise minus 1% CY1995-1997; revise locality pay beginning CY1995.....	-1,361	-1,063	-2,281	-2,741	-2,965	-8,346
Administrative Efficiencies:						
Cut 100,000 Federal employees.....	-932	-2,180	-2,306	-2,508	-2,591	-7,927
Other administrative savings.....	-675	-1,392	-2,169	-3,462	-3,553	-7,699
Reduce overhead rate on university R&D.....	-156	-330	-359	-383	-395	-1,238
Subtotal, Managing Government for Cost-Effectiveness and Results.....	-4,003	-7,511	-10,271	-13,227	-14,819	-35,012
STREAMLINING GOVERNMENT						
Agriculture.....	-36	-76	-96	-117	-139	-327
Education.....	-70	-318	-486	-620	-758	-1,494
Energy.....	-1	-1	-3	-7	-12	-11
Health and Human Services.....	-199	-500	-832	-1,168	-1,512	-2,699
Housing and Urban Development.....	-104	-265	-443	-621	-822	-1,433
Justice.....	-26	-19	-38	-56	-73	-138
Labor.....	-2	-62	-105	-161	-216	-320
Transportation.....	-10	-25	-33	-44	-54	-112
Treasury.....	-33	-52	-63	-68	-73	-216
Veterans Affairs.....	-1	-1	-3	-6	-10	-10
Corps of Engineers.....	-13	-34	-66	-77	-89	-180
Environmental Protection Agency.....	-10	-38	-70	-103	-137	-221
Other agencies.....	-100	-170	-230	-267	-292	-767
Subtotal, Streamlining Government.....	-504	-1,551	-2,458	-3,315	-4,196	-7,926

Appendix

TABLE 2. NON-DEFENSE DISCRETIONARY PROGRAM SAVINGS—Continued

(Outlays in millions of dollars)

	1994	1995	1996	1997	1998	Total
TECHNICAL ADJUSTMENTS						
Agriculture	-6	-10	-10	-10	-11	-39
Commerce	-30	-11	5	53	257	17
Education	66	122	131	135	134	454
Energy	214			-35	-144	179
Health and Human Services	-105	-91	-74	-61	-46	-331
Interior:						
Indian Land and Water Rights Claim Settlements	200	200	200	200	200	800
Other Interior programs	2	0	-4	-8	-10	-10
Justice	41	55	65	72	78	233
Labor:						
Unemployment Insurance administration workload adjustment	130	133	125	119	143	508
Other Labor programs	-54	-104	-355	-270	-291	-783
State	169	106	147	79	117	501
Transportation	104	122	127	135	144	488
Treasury:						
United States Customs	29	29	30	31	32	119
Fund additional IRS tax compliance efforts	143	156	163	171	179	633
Environmental Protection Agency	-15	-59	-85	-102	-104	-271
General Services Administration	-89	-60	-95	-222	-323	-497
Office of Personnel Management	3	9	8	5	9	25
Funds Appropriated to the President International Affairs programs	236	469	533	580	540	1818
Other agencies	83	250	131	110	97	574
Subtotal, Technical Adjustments	1,118	1,196	1,122	982	1,008	4,418
TOTAL, all categories	-4,478	-10,193	-15,406	-20,218	-23,010	-60,295

Appendix

TABLE 3. PROPOSED CHANGES TO MANDATORY PROGRAMS

(Outlays in millions of dollars)

	1994	1995	1996	1997	1998	Total
ELIMINATING SUBSIDIES: CHARGING FEES FOR GOVERNMENT SERVICES						
Energy:						
Return Power Marketing Administration			-100	-100	-100	-200
Natural Resources and Environment:						
Phase-in increased inland Waterway user fees	-35	-115	-210	-480	-460	-620
Increase grazing fees: Agriculture Department	-2	-6	-6	-13	-19	-26
Increase grazing fees: Interior Department	-4	-6	-14	-22	-32	-48
Implement a Federal irrigation water surcharge	-10	-10	-10	-15	-15	-45
Increase recreation fees: Corps of Engineers	-18	-18	-18	-18	-18	-72
Increase recreation fees: Interior Department	-29	-34	-39	-45	-50	-147
Increase recreation fees: Agriculture Department	-10	-11	-12	-13	-13	-46
Permanently extend hardrock mining holding fees	-80	-80	-80	-80	-80	-320
Institute hardrock mining royalties		-63	-131	-277	-277	-471
Improve enforcement of harbor maintenance fees	-10	-25	-65	-65	-65	-165
Permanently extend 50% net receipt sharing (on-shore minerals)	-40	-42	-43	-45	-47	-170
Below-cost timber sales (loss of receipts)	38	48	58	58	58	202
Agriculture:						
Eliminate subsidies to honey producers	-12	-10	-6	-4	-3	-32
Target CCC subsidies to farmers with off-farm incomes below \$100,000	-75	-115	-140	-140	-140	-470
Increase non-eligible payment acres (triple base) starting in 1996			-310	-720	-720	-1,030
Eliminate Q92 and SQ92 (PAY92) programs starting in 1996			-273	-684	-640	-937
Increase assessments on "non-program" crops starting in 1996			-450	-450	-450	-900
Limit payments on wool and mohair to \$50 thousand per person	-10	-68	-68	-66	-66	-212
Permanently extend market promotion program at 1983 level	-52	-52	-52	-52	-52	-208
Commerce and Housing Credit:						
Assess examination fees for State-chartered, FDIC-insured banks	-255	-255	-275	-286	-297	-1,081
Institute Commodity Futures Trading Commission processing fees (revenue)	-55	-57	-60	-63	-66	-235
Increase Securities and Exchange Commission registration fees (revenue)	-44	-46	-48	-50	-52	-188
Permanently extend patent and trademark fees			-111	-115	-120	-226
Transportation:						
Increase registration fee on general aviation aircraft	-18	-31	-44	-58	-60	-151
Permanently extend tonnage fees			-67	-68	-70	-135
Health:						
Complete payment of outstanding postal liabilities: FEHB portion		-116	-116	-116		-348
Income Security:						
Charge fee for State SSI administration	-50	-110	-180	-180	-190	-520
Administration of Justice:						
Permanently extend U.S. Customs merchandise and passenger processing fees			-564	-572	-597	-1,143

Appendix

TABLE 3. PROPOSED CHANGES TO MANDATORY PROGRAMS—Continued

(Outlays in millions of dollars)

	1994	1995	1996	1997	1998	Total
Undistributed Offsetting Receipts:						
Auction Federal Communications Commission spectrum		-374	-1,623	-2,083	-340	-4,080
Complete payment of outstanding postal liabilities: Cost-of-living adjustments for retirees		-231	-231	-231		-693
Subtotal, Eliminating Subsidies: Charging fees for Government Services	-771	-1,838	-5,290	-7,020		
MANAGING GOVERNMENT FOR COST-EFFECTIVENESS AND RESULTS						
Agriculture:						
Reform crop insurance program through area-yield (mandatory savings)		-238	-246	-255	-264	-739
Reform commodity disaster payments						
Commerce and Housing Credit:						
Government National Mortgage Association: Real estate mortgage insurance conduits	-126	-146	-146	-146	-146	-584
Reform Federal Housing Administration Insurance	-28	-56	-78	-81	-83	-253
Education, Training, Employment, and Social Services:						
Reform student loan program	171	213	-378	-1,343	-1,833	-1,337
Require States to share default costs	-80	-122	-126	-131	-137	-496
Income Security:						
Conform CSRS/FERS child-survivor benefits age to Social Security	-5	-10	-15	-20	-25	-80
Base CSRS/FERS survivor annuities on reduced retiree annuity	-35	-70	-105	-140	-175	-330
Veterans Benefits and Services:						
Restore 1.9 contribution ratio for GI Bill benefits	-68	-83	-90	-98	-108	-339
Implement housing down-payment for second and subsequent uses	-17	-17	-17	-17	-17	-68
Pay insurance administration from excess funds	-25	-28	-29	-31	-32	-113
Set housing loan fees at 2%	-153	-155	-155	-157	-165	-620
Permanently extend pensions-medicare nursing homes provisions					-300	
Permanently extend pension/medical care income verification through Internal Revenue Service					-197	
Permanently extend medical care costs recovery	-45	-326	-301	-407	-425	-1,170
Permanently extend prescription charge/co-payment					-42	
Permanently extend resale loan loss provisions	-19	-20	-20	-21	-22	-80
Administration of Justice:						
Reform U.S. Customs overtime	-18	-18	-18	-18	-18	-72
General Government:						
Implement Commonwealth of the Northern Mariana Islands funding agreement	-6	-7	-8	-10	-12	-31
Net Interest:						
Shorten maturity of debt securities	-1,634	-2,660	-3,264	-3,919	-4,577	-11,477

Appendix

TABLE 3. PROPOSED CHANGES TO MANDATORY PROGRAMS—Continued

(Outlays in millions of dollars)

	1994	1995	1996	1997	1998	Total
Other:						
FTE cut—offsets—employer contributions	115	259	284	310	320	978
FTE cut—offsets—employee contributions	29	67	71	77	80	244
Pay reduction—related employee contributions	71	95	109	131	141	406
Increase revenues from IRS tax compliance efforts	-11	-74	-297	-654	-601	-936
Subtotal, Managing Government for Cost-effective- ness and results	-1,905	-3,306	-4,919	-6,830	-8,938	-17,050
CONTROLLING HEALTH CARE COSTS						
Health:						
Institute Medicare fee limits over 65: Federal Employees Health Benefits	-12	-18	-21	-24	-27	-75
Medicaid: Eliminate mandatory medicaid care	-1,190	-1,355	-1,540	-1,760	-1,980	-4,085
Medicaid: Tighten estate asset rules	-25	-80	-135	-155	-170	-395
Medicaid: Remove prohibition on drug trademarks	-10	-15	-20	-25	-30	-70
Medicare:						
Pay hospitals for inpatient services by hospital-based physi- cians	-60	-150	-180	-180	-180	-390
Put hospitals on a calendar year update	-1,000	-1,140	-1,290	-1,420	-1,540	-4,610
Gradually lower indirect medical education rate to 5.6%	-680	-680	-680	-680	-680	-3,400
Set laboratory rates at market levels	-390	-690	-860	-1,120	-1,390	-3,050
Eliminate skilled nursing facility return on equity payments	-110	-140	-150	-160	-170	-560
Durable medical equipment—options	-75	-125	-150	-160	-175	-510
Set erythropoietin (EPO) at non-U.S. market rates (\$10 per 1000 units)	-30	-40	-40	-50	-50	-160
Medicare secondary payor (MSP) reforms	-127	-240	-275	-305	-345	-947
Eliminate add-on for hospital based home health agency	-160	-200	-230	-250	-280	-840
Phase-in resource-based practice expense	-100	-350	-700	-875	-950	-2,025
Implement single fee for surgery	-60	-100	-110	-120	-130	-380
Discount for interjections	160	200	490	940	1,410	1,790
Reduce hospital update market basket minus 1% in 1994 and 1995	-550	-1,380	-1,560	-1,700	-1,860	-5,190
Permanently extend 10% capital reduction, outpatient de- partment	-110	-220	-220	-220	-220	-990
Permanently extend 2% laboratory fee update	-30	-110	-220	-360	-570	-740
Permanently extend 10% capital reduction, Prospective Payment System neutral	-300	-380	-420	-420	-420	-1,640
Permanently extend Medicare Secondary Payer (MSP) for the disabled	-650	-960	-1,085	-1,160	-1,240	-4,195
Permanently extend MSP for End Stage Renal Disease af- ter 18 months	-35	-35	-35	-35	-35	-140
Permanently extend Internal Revenue Service/Social Secu- rity Administration/Health Care Financing Administration data match	-45	-120	-205	-205	-205	-680
Permanently extend reduction of payments for hospital out- patient services by 5.8%	-425	-525	-600	-600	-600	-2,350
Third party liability—Enhance identification of other health coverage	-150	-250	-400	-450	-450	-1,300
Direct medical education	-350	-340	-340	-330	-320	-1,380
Ban physician self referrals	-50	-100	-100	-100	-100	-450
Reduce default Medicare volume performance and update	-290	-650	-1,225	-1,225	-1,225	-3,615

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Appendix

TABLE 3. PROPOSED CHANGES TO MANDATORY PROGRAMS—Continued

	(Outlays in millions of dollars)					Total
	1994	1995	1996	1997	1998	
Reduce doctor fees in 1994 except primary care.....	-200	-300	-350	-400	-425	-1,250
Provide electronic billing incentive.....			-60	-175	-175	-265
Outpatient department cut at 10%.....			-315	-375	-425	-690
Medicare—Maintain 1995 ratio of premium collections to program outlays with a 27% ceiling.....			-1,145	-3,870	-6,560	-5,015
Subtotal, Controlling Health Care Costs.....	-3,050	-6,538	-11,631	-17,204	-21,892	-36,432
SHARED CONTRIBUTION						
Health:						
Medicaid: Equate matching rates for welfare program.....	-160	-400	-440	-490	-540	-1,490
Social Security:						
Retain Social Security threshold and tax 65% (revenue).....	-2,700	-5,600	-6,200	-6,900	-7,700	-21,400
Income Security:						
Strengthen child support enforcement.....	-27	-80	-112	-100	-177	-328
Equate matching rates for welfare program.....	-40	-80	-90	-60	-60	-300
End lump-sum benefit.....			-2,100	-3,032	-3,197	-6,132
Subtotal, Shared Contribution.....	-2,927	-6,160	-8,942	-10,521	-11,704	-29,650
TOTAL, PROPOSED ENTITLEMENT SAVINGS.....	-8,662	-17,832	-30,782	-41,675	-47,515	-99,051
MEMORANDUM:						
Revenue items included above.....	-2,755	-5,755	-6,700	-7,884	-8,723	-23,094

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Change in Federal Taxes and Certain Transfer Payments*

(positive numbers are additional tax revenues, negative numbers are outlays)

Family income	Amount (billions)	As a Percent of Pre-tax income	As a Percent of Post-tax income
\$0 to \$10,000	(\$0.2)	-0.2%	-0.2%
\$10,000 to \$20,000	\$0.0	0.0%	0.0%
\$20,000 to \$30,000	\$0.4	0.1%	0.1%
\$30,000 to \$50,000	\$4.4	0.5%	0.6%
\$50,000 to \$75,000	\$7.6	0.7%	0.9%
\$75,000 to \$100,000	\$5.9	0.7%	0.9%
\$100,000 to \$200,000	\$8.0	0.7%	0.9%
\$200,000 and more	\$34.3	2.9%	3.7%
Total	\$60.5	1.0%	1.3%

* Effects as if policies were fully phased-in in FY1994. Transfer payments include increases of \$3 billion for Food Stamps and \$1 billion for LIHEAP.

Change in Federal Outlays for Social Programs and Federal Pay**

(positive numbers are additional outlays, negative numbers are savings)

Family income	Amount (billions)	As a Percent of Pre-tax income
\$0 to \$10,000	\$3.6	3.7%
\$10,000 to \$20,000	\$1.3	0.5%
\$20,000 to \$30,000	\$0.0	0.0%
\$30,000 to \$50,000	(\$0.8)	-0.1%
\$50,000 to \$75,000	(\$0.9)	-0.1%
\$75,000 to \$100,000	(\$0.6)	-0.1%
\$100,000 and more	(\$0.6)	-0.1%
Total	\$2.3	0.1%

** FY1997 spending levels deflated to FY1994 dollars. Includes increases of \$8.9 billion and savings of \$6.6 billion for a net proposed change of \$2.3 billion. Increases are for Head Start and associated nutrition programs (\$3.4 billion), youth titles of JTPA (\$0.8 billion), housing programs (\$1.1 billion), WIC (\$0.9 billion), displaced workers (\$1.8 billion), one-stop career shopping (\$0.2 billion), and veterans medical care and construction (\$0.6 billion). Savings are for lower Federal salaries (\$3.0 billion), Federal employees health benefits (\$0.02 billion), and higher Medicare premiums (\$3.6 billion).

Combined Effects of Tax and Transfer Changes

(positive numbers are additions to family income, negative numbers are income losses)

Family income***	Amount (billions)	As a Percent of Pre-tax income
\$0 to \$10,000	\$3.8	4.5%
\$10,000 to \$20,000	\$1.3	0.4%
\$20,000 to \$30,000	(\$0.3)	-0.1%
\$30,000 to \$50,000	(\$5.2)	-0.6%
\$50,000 to \$75,000	(\$8.5)	-0.8%
\$75,000 to \$100,000	(\$6.4)	-0.7%
\$100,000 and more	(\$42.8)	-1.8%
Total	(\$58.2)	-4.9%

*** The concepts of family income used in the tax and spending tables above are not strictly comparable. The tax table reflects the Department of the Treasury's concept of economic family income. The outlay table reflects the concept of money income employed by the Bureau of the Census. To combine the tax and outlay effects, amounts of taxes and outlays were compared to aggregates of Treasury family income by income level from the tax table.

REVENUE PROVISIONS

Proposal	Fiscal years						
	1993	1994	1995	1996	1997	1998	1999
	(\$ millions)						

REVENUE RAISING PROVISIONS

1 Provisions That Improve the Fairness of the Income Tax System

a Increase tax rates paid by high-income individuals [1]	1,750	27,680	19,880	22,920	26,340	27,740	126
1 Add fourth bracket at 38% rate for taxable income over \$140,000 (joint returns), \$127,500 (heads of households), \$118,000 (single)							
2 Impose a 10% surtax on regular taxable income over \$250,000 (not applicable to capital gains)							
3 Increase in minimum tax rate to 26% for AMTI of less than \$175,000 and 28% for AMTI over \$175,000; increase AMTI exemption to \$45,000 (joint returns) and \$37,500 (single)							
4 Extend itemized deduction limitation and personal exemption phaseout scheduled to expire for 1998 and 1997, respectively							
b Repeal Health Insurance wage base cap	0	2,760	6,030	6,374	6,808	7,200	21
c Reinstatement of top estate tax rates at 53% and 55% [2]	0	475	612	553	588	647	2
d Reduce deductible portion of business meals and entertainment from 80% to 50%	0	1,816	3,179	3,437	3,697	3,980	11
e Deny deduction for club dues	0	147	248	255	282	295	1
f Deny deduction for executive pay over \$1 million	-19	137	77	149	153	146	
g Reduce compensation that can be taken into account for purposes of benefits and contributions under qualified retirement plans to \$150,000 in 1994 (1993 cap is \$235,840)	0	304	775	814	855	897	2
h Disallow moving deductions for meals and real estate expenses	0	76	382	394	406	417	1

2 Provisions Affecting Businesses

a Increase corporate tax rate to 38% for taxable income above \$10 million (phase-out benefit of 34% rate beginning at \$16 million) [1]	368	7,742	5,402	5,549	5,706	5,825	31
b Deny deduction for lobbying expenses	0	112	196	210	223	237	
c Require securities dealers to mark-to-market [3]	0	457	1,090	1,106	1,128	887	
d Prohibit double-dip related to FSUC assistance [4]	757	681	80	17	206	79	
e Extend corporate estimated tax rules	0	0	0	0	3,891	794	
f Limit 936 credit to 85% of compensation	0	223	876	1,599	2,078	2,235	

REVENUE PROVISIONS

Proposal	Fiscal years						
	1993	1994	1995	1996	1997	1998	1999
	(\$ millions)						
3 Provisions Affecting International Businesses							
a Reform foreign tax credit for oil multinationals	0	178	362	380	419	461	
b Transfer pricing compliance initiative (enhanced penalty provision)	0	250	650	900	1,000	1,000	
c Royalties in passive basket of foreign tax credit; 100% R&E allocation	0	191	330	374	412	453	
d Enhance "earnings stripping" rules	6	88	118	120	122	126	
e Repeal deferral for excessive accumulated foreign earnings	0	100	150	150	150	150	
4 Energy Provisions (5)							
a Modified BTU tax	0	1,476	8,924	16,359	22,277	22,405	7
b Extend gasoline tax currently scheduled to expire on 9/30/95	0	0	0	2,627	2,614	2,632	
5 Compliance Initiatives							
a Service industry non-compliance initiative / TIN validation	0	152	636	1,372	1,919	2,270	
b Modified substantial understatement penalty	0	321	551	418	332	349	
6 Miscellaneous							
	0	827	133	-171	174	179	
TOTAL	2,882	48,063	50,591	65,908	81,768	81,136	32

REVENUE PROVISIONS

Proposal	02/17/83						
	Fiscal years						
	1993	1994	1995	1996	1997	1998	1999
	(\$ millions)						

STIMULUS / INVESTMENT PROVISIONS

1 Training and Education

a Extend employer-provided education assistance permanently	-470	-425	-458	-492	-528	-565	-1
b Extend targeted jobs tax credit permanently	-23	-143	-248	-288	-344	-415	-
c Youth apprenticeship credit	0	-27	-79	-118	-152	-190	-

2 Capital Investment and Economic Growth

a Temporary incremental tax credit for large businesses and permanent investment tax credit for businesses with gross receipts of under \$5 million	-4,581	-9,194	-6,717	-3,134	-2,348	-2,829	-2
b Extend research & experimentation credit permanently	-944	-1,207	-1,503	-1,750	-1,977	-2,200	-1
c Incentives for investment in small businesses	0	-12	-83	-155	-207	-247	-
d Modify AMT depreciation schedule	-70	-188	-307	-396	-404	-273	-
e Incentives for high-speed rail	0	0	-1	-4	-11	-20	-
f Extend small-issue manufacturing and agricultural bonds permanently	-3	-14	-28	-35	-37	-37	-

3 Enterprise Zones

	0	-73	-347	-772	-1,228	-1,699	-
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4 Expand Earned Income Tax Credit [8]

	0	-525	-6,228	-6,445	-6,862	-6,927	-2
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5 Investment in Real Estate

a Extend mortgage revenue bonds permanently	-44	-214	-478	-791	-1,114	-1,442	-
b Extend low-income housing credit permanently	-38	-104	-145	-160	-172	-174	-
c Modify rules governing tax treatment of investments in real estate (passive loss rules, pension investments, and increase recovery period for non-residential real property to 38 years)	0	-254	-387	-164	-17	158	-

REVENUE PROVISIONS

Proposal	Fiscal years						
	1993	1994	1995	1996	1997	1998	1999
	(\$ millions)						
6 Other							
a Extend AMT treatment of gifts of appreciated property to charities permanently	-26	-70	-73	-75	-77	-79	
b Extend general fund transfer to railroad retirement fund permanently	0	0	0	0	0	0	
c Extend 25% deduction for self-employed health insurance through 12/31/93	-263	-313	0	0	0	0	
TOTAL	-6,442	-12,703	-17,092	-14,779	-16,278	-17,038	-8
NET TOTAL:	-3,680	33,300	33,499	51,127	68,490	64,097	24

Note: Provisions effective 1/1/94 unless otherwise noted.

[1] Effective 1/1/93, but no penalties for underwithholding or estimated tax in 1993.

[2] Effective 1/1/93.

[3] Effective for tax years ending on or after 12/31/93.

[4] Estimate does not include effect on OMB outlays; special effective date.

[5] Impact on low-income households offset by increases in the low-income home energy assistance program (LIHEAP) and food stamps.

[6] Estimate includes effect on outlays.

Administration's Revenue Proposals
(Offsets: Expansion of EITC and Increases in LIHEAP and Food Stamp programs)
(Includes Taxation of Social Security Benefits)
(1994 Income Levels)

TOTAL P.43

Family Economic Income Class (4) (000)	Federal Taxes Under Current Law (2)			Change in Federal Taxes (3)			Total Federal Taxes After Change		
	Amount (\$)	As a Percent of Pre-Tax Income (%)	As a Percent of After-Tax Income (%)	Amount (\$)	As a Percent of Pre-Tax Income (%)	As a Percent of After-Tax Income (%)	Amount (\$)	As a Percent of Pre-Tax Income (%)	As a Percent of After-Tax Income (%)
0 - 10	6.7	7.8	8.6	-0.2	-0.2	-0.2	6.5	7.6	8.3
10 - 20	26.9	9.8	10.9	0.0	0.0	0.0	26.9	9.8	10.9
20 - 30	55.7	14.0	16.3	0.4	0.1	0.1	56.0	14.1	16.4
30 - 50	182.1	17.3	20.9	4.4	0.5	0.6	186.5	17.8	21.5
50 - 75	203.1	19.0	23.6	7.8	0.7	0.9	210.7	19.7	24.3
75 - 100	174.3	20.4	25.6	5.8	0.7	0.9	180.2	21.1	26.5
100 - 200	242.6	21.2	26.8	8.0	0.7	0.9	250.6	21.8	27.7
200 & over	247.8	20.9	26.5	34.3	2.9	3.7	281.8	23.8	30.2
Total (5)	1,110.6	19.0	23.4	60.4	1.0	1.3	1,170.9	20.0	24.7

Department of the Treasury
Office of Tax Analysis

February 18, 1993

- (1) This table distributes the estimated change in tax liabilities due to possible revenue options, including taxation of Social Security benefits. Included is a total of \$10.2 billion of expansions in the EITC and increases in transfers for Food Stamps and the Low-Income Home Energy Assistance Program.
- (2) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Taxes due to provisions that expire prior to the end of the Budget period (i.e., before 1999) are excluded.
- (3) The change in Federal taxes is estimated at 1994 income levels but assuming fully phased in (1998) law and long-run (1998) behavior. All excise and payroll tax effects on indexed transfers and tax brackets are accounted for. All income, payroll, and excise tax changes are included, with the exception that provisions which only affect the timing of tax collections are excluded. The incidence assumptions for tax changes are the same as for current law taxes (see footnote 2).
- (4) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments, such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family, rather than on a tax return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.



DEPARTMENT OF THE TREASURY
EMBASSY OF THE
UNITED STATES OF AMERICA

London

Fax Number: 071-408-2081

27/1/93

FROM: William McFadden, Financial Attache

TELEPHONE: 408-8069

Number of Pages (including cover sheet): 2

TO:

Sir Nigel Wicks - HM Treasury
Mr. Andrew Crockett - Bank of England
Mr. Stephen Collins - Bank of England
Mrs. Mary Francis - #10 Downing St.

MESSAGE:

Prime Minister

CLINTON CREATES COUNCIL TO COORDINATE ECONOMIC POLICY

(Membership includes eight cabinet officers)

Washington -- President Clinton has signed an executive order formally establishing a new National Economic Council to coordinate domestic and international economic policy in his administration.

"I believe that this will enable us to make economic policy in a much more specific, clear and effective way than the federal government has in quite a long while," Clinton said January 25.

The executive order says that Clinton will preside over meetings of the council, which will be directed on a day-to-day basis by Robert Rubin, his assistant for economic policy.

In Clinton's absence, Vice President Gore will preside, or in his absence Rubin will preside.

Either the president or Rubin may convene meetings of the council, which will have a full staff of its own to coordinate and monitor the formation and implementation of U.S. economic policy much as the National Security Council presently does for foreign policy.

All executive departments and agencies of the federal government must coordinate economic policy through the council, even if they are not represented on that body.

"The secretary of the treasury will continue to be the senior economic official in the executive branch and the president's chief economic spokesperson," the executive order said. "The director of the Office of Management and Budget, as the president's principal budget spokesperson, will continue to be the senior budget official in the executive branch. The Council of Economic Advisers will continue its traditional analytic, forecasting and advisory functions."

Members of the National Economic Council include eight cabinet officers: Secretary of State Warren Christopher, Secretary of the Treasury Lloyd Bentsen, Secretary of Agriculture Mike Espy, Secretary of Commerce Ron Brown, Secretary of Labor Robert Reich, Secretary of Housing and Urban Development Henry Cisneros, Secretary of Transportation Federico Pena and Secretary of Energy Hazel O'Leary.

Other members are Carol Browner, administrator of the Environmental Protection Agency; Leon Panetta, director of the Office of Management and Budget; Laura Tyson, head of the president's Council of Economic Advisers; Mickey Kantor, U.S. Trade Representative; Carol Rasco, assistant to the president for domestic policy; John Gibbons, assistant to the president for science and technology; Anthony Lake, National Security Advisor; and "such other officials of the executive departments and agencies as the president may, from time to time, designate."

Most of these officials have already been confirmed by Congress.

F A X M E S S A G E

File

DEPARTMENT OF THE TREASURY
EMBASSY OF THE
UNITED STATES OF AMERICA

London

Fax Number: 071-408-2081

27/1/93

FROM: William McFadden, Financial Attache

TELEPHONE: 408-8069

Number of Pages (including cover sheet): 2

TO:

Sir Nigel Wicks - HM Treasury
Mr. Andrew Crockett - Bank of England
Mr. Stephen Collins - Bank of England
Mrs. Mary Francis - #10 Downing St.

MESSAGE:

Prime Minister

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CLINTON CREATES COUNCIL TO COORDINATE ECONOMIC POLICY

(Membership includes eight cabinet officers)

Washington -- President Clinton has signed an executive order formally establishing a new National Economic Council to coordinate domestic and international economic policy in his administration.

"I believe that this will enable us to make economic policy in a much more specific, clear and effective way than the federal government has in quite a long while," Clinton said January 25.

The executive order says that Clinton will preside over meetings of the council, which will be directed on a day-to-day basis by Robert Rubin, his assistant for economic policy.

In Clinton's absence, Vice President Gore will preside, or in his absence Rubin will preside.

Either the president or Rubin may convene meetings of the council, which will have a full staff of its own to coordinate and monitor the formation and implementation of U.S. economic policy much as the National Security Council presently does for foreign policy.

All executive departments and agencies of the federal government must coordinate economic policy through the council, even if they are not represented on that body.

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Most of these officials have already been confirmed by Congress.

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TREASURY FOR SEDGWICK AND SHARPLES
BANK OF ENGLAND FOR COLLINS
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DOE FOR FISK

POINTERS TO FIRST CLINTON BUDGET

SUMMARY

1. BENTSEN HINTS THAT ENERGY TAX UNDER CONSIDERATION. EXPECTED DATE OF BUDGET SLIPPING.

DETAIL

2. IN A TELEVISION APPEARANCE ON SUNDAY, NEW TREASURY SECRETARY LLOYD BENTSEN STATES FIRMLY THAT QUOTE SOME CONSUMPTION TAX IS GOING TO TAKE PLACE UNQUOTE WHILE KEEPING HIS OPTIONS OPEN ON TIMING. PRESSED ON THE NATURE OF SUCH A TAX, BENTSEN STRESSED THAT DECISIONS HAD NOT YET BEEN TAKEN. OPTIONS WOULD INCLUDE A GASOLINE TAX, A BROADER-BASED ENERGY TAX, AND HIGHER TAXES ON ALCOHOL AND TOBACCO. HE DID NOT SEE A NATIONAL SALES TAX QUOTE AT THIS POINT AS SOMETHING THAT WILL BE DONE UNQUOTE. HE SPOKE PARTICULARLY WARMLY OF THE ENVIRONMENTAL BENEFITS OF RAISING ENERGY PRICES THROUGH TAXATION.

3. THIS WAS THE CLEAREST PUBLIC INDICATION SO FAR THAT THE ADMINISTRATION WILL INCREASE TAXES TO DEAL WITH THE BUDGET PROBLEM. OTHER THAN FOR THE HIGHEST PAID, HOWEVER, INCREASED INCOME TAXES ARE NOT ON THE AGENDA. BENTSEN IS KNOWN TO OPPOSE A VAT ON DISTRIBUTIONAL GROUNDS. IN HER CONFIRMATION HEARING LAST WEEK, ENERGY SECRETARY HAZEL O'LEARY SAID SHE DID NOT EXPECT AN INCREASE IN GASOLINE TAX IN 1993.

4. THE ADMINISTRATION PLAN TO INTRODUCE A SUMMARY BUDGET FOR FY 1994 NEXT MONTH. THIS WILL SET OUT ALL THE MAIN TAX AND SPENDING

PROPOSALS, TOGETHER WITH AGGREGATE SPENDING AND DEFICIT PROJECTIONS. OMB DIRECTOR PANETTA HAD INDICATED THAT THIS WOULD BE AT THE BEGINNING OF FEBRUARY, BUT OMB OFFICIALS NOW TELL US THIS WILL NOT BE BEFORE THE WEEK BEGINNING 15 FEBRUARY. SIMILARLY, THE LIKELY PUBLICATION OF A FULL BUDGET, INCLUDING DETAILED FIGURES, HAS SLIPPED FROM MID-MARCH TO END-MARCH.

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ENGLAND FOR COLLINS

UNITED STATES MONTHLY ECONOMIC REPORT : DECEMBER 1992

SUMMARY

1. CONTINUING EVIDENCE THAT US RECOVERY BECOMING MORE SOLID.

ACTIVITY

2. FINAL FIGURES FOR THE THIRD QUARTER GDP SHOWED A GROWTH RATE OF 3.4 PER CENT IN THE QUARTER, A DOWNWARD REVISION OF HALF A PER CENT DRIVEN MAINLY BY LOWER ESTIMATES OF STOCKBUILDING. THE MAIN FEATURE OF THE THIRD QUARTER'S GROWTH WAS A BOOM IN CONSUMPTION WHICH WAS NOT AFFECTED BY THE REVISIONS.

3. MONTHLY INDICATORS SUGGEST THE STRENGTH OF CONSUMPTION IS CONTINUING INTO THE FOURTH QUARTER GIVING A SOLID BASE FOR THE QUARTER'S GDP GROWTH. RETAIL SALES WERE UP 0.4 PER CENT IN NOVEMBER AFTER A STRONG INCREASE OF 1.9 PER CENT IN OCTOBER. REAL PERSONAL CONSUMPTION GREW 0.3 PER CENT LN NOVEMBER AFTER 0.6 PER CENT GROWTH IN OCTOBER. AND CONSUMER CONFIDENCE HAS REBOUNDED STRONGLY IN NOVEMBER AND DECEMBER.

4. INDUSTRIAL PRODUCTION ALSO LOOKS HEALTHY, RISING 0.4 PER

CENT IN NOVEMBER, AFTER AN UPWARD REVISED 0.5 PER CENT IN OCTOBER. AND WHILE DURABLE GOODS ORDERS FELL 1.9 PER CENT IN NOVEMBER, THEY HAVE INCREASED AT AN ANNUAL RATE OF OVER 12 PER CENT DURING THE PAST THREE MONTHS. THE HOUSING MARKETS STILL REMAINS A LITTLE SLUGGISH, WITH STARTS RISING 1.5 PER CENT IN NOVEMBER.

5. OVERALL THE MONTHLY INDICATORS SUGGEST THAT GDP GROWTH IN THE FOURTH QUARTER OF 1992, ALTHOUGH NOT AS STRONG AS IN THE THIRD, WILL BE AT A VERY RESPECTABLE RATE, PROBABLY IN EXCESS OF 2 PER CENT, IMPLYING YEAR ON YEAR GROWTH FOR 1992 AS A WHOLE OF 2 PER CENT OR HIGHER.

THE LABOUR MARKET

6. THERE WAS SOME MODEST IMPROVEMENT IN THE LABOUR MARKET IN DECEMBER, WITH NON FARM PAYROLLS RISING 64,000. HOWEVER, THE UNEMPLOYMENT RATE WAS UNCHANGED AT 7.3 PER CENT. THESE FIGURES HAVE BEEN MET WITH SOME DISAPPOINTMENT, BUT THE LABOUR MARKET HAS BEEN IMPROVING STEADILY OVER THE PAST FEW MONTHS. MANUFACTURING EMPLOYMENT GROWTH WAS MODEST IN DECEMBER, RISING JUST 3,000 BUT STRONG LAST MONTH. IN CONTRAST, SERVICE PRODUCING INDUSTRIES ADDED 68,000 IN DECEMBER.

INFLATION

7. INFLATIONARY PRESSURES REMAIN VERY WEAK. OCTOBER CONSUMER PRICE INFLATION WAS 3.0 PER CENT AND PRODUCER PRICE INFLATION 1.3 PER CENT. THE PROSPECTS ARE FOR VIRTUALLY NO PICK UP IN INFLATION OVER THE NEXT TWELVE MONTHS, WITH THE BLUE CHIP CONSENSUS FORECAST FOR THE CPI FOR 1993 BEING 3.2 PER CENT.

MARKETS

8. WITH NO CHANGE IN INTEREST RATES IN DECEMBER, MUCH OF THE INCREASE IN LONGER RATES SEEN LEADING UP TO AND JUST AFTER THE PRESIDENTIAL ELECTION WAS DISSIPATED, ALBEIT IN THIN TRADING LEADING UP TO THE CHRISTMAS PERIOD. THE DOLLAR RALLY IN NOVEMBER EASED OFF IN DECEMBER AS THE PROSPECTS OF INTEREST RATE REDUCTION IN EUROPE AND JAPAN APPEARED TO RECEDE. BUT THE EQUITY MARKET RALLY OF THE SECOND HALF OF NOVEMBER CONTINUED IN THE FIRST HALF OF DECEMBER, THOUGH IT WAS DISRUPTED BRIEFLY BY NEWS OF RESTRUCTURING AT IBM INVOLVING

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THE LOSS OF 25,000 JOBS.

VISIBLE TRADE

9. THE MERCHANDISE TRADE DEFICIT NARROWED 1.5 BILLION DOLLARS TO 7.0 BILLION DOLLARS IN OCTOBER, MAINLY REFLECTING STRONG EXPORT GROWTH OF 3.4 PER CENT, BASED ON A SURGE IN AGRICULTURAL EXPORT.

FEDERAL DEFICIT

10. THE FEDERAL BUDGET WAS IN DEFICIT BY 32.7 BILLION DOLLARS IN NOVEMBER, THE SECOND MONTH OF THE 1993 FISCAL YEAR. REVISED BUDGET PROJECTIONS BY THE OUTGOING ADMINISTRATION FORECAST A DEFICIT OF 327 BILLION DOLLARS IN FY 1993, A DECLINE TO 266 BILLION DOLLARS BY 1996, THEN A RENEWED RISE TO 320 BILLION DOLLARS IN FY 1998.

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PRIME MINISTER

Alan Greenspan

I had a general discussion with Mr Greenspan on Friday about the US economy, the Clinton Administration, the UK economy and the international scene, and a private discussion which is recorded separately.

On the US economy, he was bullish. He expected the third quarter gdp figure to be revised down from 3.9 per cent, but no lower than 3.5 per cent. He also expected growth in the fourth quarter to be of the order of 3.5 per cent, suggesting strong growth next year. And inflation was firmly under control; possibly still trending downwards. One adverse point to note, however, was that the trade position was not as good as reported. The quarterly current account figures would be less strong than the monthly trade figures suggested, since exports were boosted by a gold shipment which is subsequently netted out.

The US was experiencing a "productivity recovery" generated by a step-change in the quality of computer software. Over the past decade, a great deal of investment had been made in computer technology, but the software had lagged behind, leading to inefficient use of this new capital. Now the US had entered a period of catching-up, with consequent effects on productivity and output.

Consumption was providing a boost, helped by an increase in housing turnover, a modest pick-up in house prices (although commercial property was still depressed) and in housing starts.

However, Mr Greenspan had two concerns. Domestically, he believed there was still a severe shortage of capital for small and medium-sized businesses, because the banks were taking a very restrictive attitude to lending. This was a serious worry, since these businesses were the chief source of new jobs: large

Knowledge of UK economy.

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corporations were still shedding jobs and would continue to do so.

His second anxiety was the state of the world economy, and the resulting danger of financial crisis, about which he thought there was insufficient international concern. He was very worried about Germany, which he thought could lead a sharp European downturn. And he was also concerned about Japan, though he agreed with me that the south-east Asian economies were busy disproving the theory that they could not grow without a lead from the industrialised world in general and Japan in particular.

He asked about the UK. I gave a cautious picture: low inflation, lower interest rates, retail sales modestly encouraging, exports likely to benefit from more competitive exchange rate, provided inflation was not allowed to pick up, UK well-placed to benefit from the Single Market; but sharp reductions in employment this year, unemployment rising, housing market still weak, confidence indicators erratic. He said he thought there was every advantage in you and the Chancellor sounding cautious; none in proclaiming recovery too early in shaky times. Confidence indicators were unreliable; he had decided that in the US they lagged rather than led consumer spending: ie, people did not go out and spend because they felt good, but they felt good after they had been out spending!

He complimented you on Edinburgh, and I ran him through the details. So far as the Clinton Administration was concerned, he believed the prospect of a fiscal stimulus was fading fast. He had had long talks with Governor Clinton, and was greatly impressed by his command of issues and of detail. The "economic summit", about which Mr Greenspan had been exceedingly dubious, had been a great success and a personal triumph for Mr Clinton.

Mr Greenspan was even more positive about Governor Clinton than I would have expected him to be in these delicate circumstances (and you will have noted that in that Wall Street Journal interview Mr Clinton heaped praise on Mr Greenspan). He also commented that Mr Clinton had no "officiousness" about him, and

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that this was rare in statesmen/ politicians. He could only think of one other leader so singularly lacking in that undesirable attribute, namely yourself. He was sure you would get on.

He was looking forward to seeing you on Sunday.

Sarah.

SARAH HOGG
19 DECEMBER 1992

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MIPT: CLINTON'S ECONOMIC TEAM

SUMMARY

1. CLINTON, EMPHASISING THE NEED FOR LONG TERM DEFICIT REDUCTION, NOMINATES OTHER MEMBERS OF ECONOMIC TEAM. LEON PANETTA, CHAIRMAN OF THE CONGRESSIONAL BUDGET COMMITTEE, TO BE BUDGET DIRECTOR WITH ALICE RIVLIN AS HIS DEPUTY. GOLDMAN SACHS CO-CHAIRMAN, ROBERT RUBIN, TO BE CHAIRMAN OF THE NEW WHITE HOUSE ECONOMIC COUNCIL. INVESTMENT BANKER ROGER ALTMAN TO SERVE AS BENTSEN'S DEPUTY AT TREASURY. CHAIRMAN OF THE COUNCIL OF THE ECONOMIC ADVISERS REMAINS UNDECIDED: SCOPE FOR CONFLICT BETWEEN FISCAL CONSERVATIVES SO FAR APPOINTED AND OTHER CLINTON ADVISERS.

DETAIL

2. IN ANNOUNCING HIS ECONOMIC TEAM, CLINTON EMPHASISED THE NEED FOR LONG TERM DEFICIT REDUCTION, AS DID HIS APPOINTEES.

3. CLINTON HAS APPOINTED CONGRESSMAN LEON PANETTA FROM MONTEREY, CALIFORNIA, TO REPLACE DARMAN AS BUDGET DIRECTOR. PANETTA HAS BEEN A POLITICIAN ALL HIS ADULT LIFE. HE STARTED HIS CAREER AS A REPUBLICAN WORKING IN THE OFFICE OF CIVIL RIGHTS IN THE NIXON ADMINISTRATION, BUT WAS FIRED IN 1970 FOR COMPLAINING ABOUT SLOW PROGRESS ON DESEGREGATION AND SWITCHED TO THE DEMOCRATIC PARTY IN 1971. THE 54 YEAR OLD PANETTA HAS BEEN CHAIRMAN OF THE HOUSE BUDGET COMMITTEE SINCE 1989 AND PLAYED A KEY ROLE IN THE 1990 BUDGET SUMMIT. HE IS WELL ACQUAINTED WITH THE MINUTIAE OF THE LABYRINTHINE AMERICAN BUDGET PROCESS. PANETTA IS A CENTRIST:

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FISCALLY CAUTIOUS BUT SOCIALLY LIBERAL. HE IS A DEFICIT HAWK: HE DRAFTED A LONG TERM DEFICIT REDUCTION PLAN OF HIS OWN INVOLVING SWINGELING SPENDING CUTS AND TAX INCREASES. IT WILL BE INTERESTING TO SEE WHETHER HE IS ABLE TO ACHIEVE ANYTHING OF THE KIND AT OMB.

4. ALICE RIVLIN, A 61 YEAR OLD PROFESSIONAL ECONOMIST AT THE BROOKINGS INSTITUTE, WILL BE PANETTA'S DEPUTY AS BUDGET DIRECTOR. RIVLIN SERVED IN THE JOHNSON ADMINISTRATION AS AN ASSISTANT SECRETARY IN THE HEALTH, EDUCATION AND WELFARE DEPARTMENT. SHE BECAME THE FIRST DIRECTOR OF THE CONGRESSIONAL BUDGET OFFICE IN 1975 AND SERVED THERE UNTIL 1983. SHE LEFT THE CBO WITH AN EXCELLENT REPUTATION FOR PROFESSIONAL AND NON-PARTISAN ECONOMIC FORECASTS AND ANALYSIS. SHE IS NOW A SENIOR FELLOW AT BROOKINGS. HER RECENT BOOK QUOTE REVIVING THE AMERICAN DREAM UNQUOTE PROPOSES THE RADICAL STEP OF SHIFTING GOVERNMENT PROGRAMMES LIKE JOB TRAINING AND PUBLIC WORKS AWAY FROM WASHINGTON AND DOWN TO STATE CAPITALS.

5. GOLDMAN SACHS CO-CHAIRMAN ROBERT RUBIN WILL HEAD THE NEW WHITE HOUSE ECONOMIC COUNCIL, WHICH IS TO COORDINATE DOMESTIC AND FOREIGN ECONOMIC POLICY IN PARALLEL WITH THE NATIONAL SECURITY COUNCIL. RUBIN WILL REPORT DIRECT TO THE PRESIDENT. HE WAS EDUCATED AT HARVARD, YALE LAW SCHOOL AND LSE (1960-61). HE JOINED GOLDMAN SACHS IN 1964. RUBIN, WHO IS EXTREMELY WEALTHY, SERVED AS A MAJOR FUND RAISER FOR CLINTON'S ELECTION CAMPAIGN. HE HAS A LONG BACKGROUND IN DEMOCRATIC POLITICS SERVING ON VARIOUS PRESIDENTIAL COMMISSIONS AND AS FINANCE CHAIRMAN FOR MONDALE'S PRESIDENTIAL CAMPAIGN IN 1984. HE CHAIRED THE NEW YORK HOST COMMITTEE FOR THE DEMOCRATIC CONVENTION THIS YEAR. WHILE HE HAS LESS EXPERIENCE OF DEALING WITH NATIONAL AND INTERNATIONAL POLICY ISSUES THAN MOST OF THE OTHER APPOINTEES, HE IS LIKELY TO HAVE A FIRMER GRASP OF THE REALITIES OF ECONOMIC POLICY. HIS APPOINTMENT WILL BE REASSURING TO WALL STREET. RUBIN HAS A NUMBER OF CLOSE BRITISH FRIENDS, INCLUDING MR MICHAEL HOWARD, SECRETARY OF STATE FOR THE ENVIRONMENT.

6. ROGER ALTMAN, THE 46 YEAR OLD VICE CHAIRMAN OF THE BLACKSTONE GROUP IN NEW YORK, WILL BE BENTSEN'S DEPUTY AT THE TREASURY. ALTMAN SERVED AS AN ASSISTANT SECRETARY FOR DOMESTIC FINANCE IN THE CARTER ADMINISTRATION AND PLAYED AN IMPORTANT PART IN THE RESCUE OF CHRYSLER. ALTMAN WAS A CLASSMATE OF CLINTON'S AT GEORGETOWN AND HAD BEEN CONSIDERED A POSSIBLE CANDIDATE FOR TREASURY SECRETARY HIMSELF. HE WAS AN ADVISER TO DUKAKIS DURING HIS 1988 CAMPAIGN. HE CONTRIBUTED TO CLINTON'S ECONOMIC PLAN DURING THE ELECTION AND

SERVED AS A MAJOR FUND RAISER IN NEW YORK. ALTMAN, IN RECENT STATEMENTS, HAS URGED CAUTION IN PRESSING AHEAD WITH ANY ECONOMIC STIMULUS. HE IS ASSOCIATED WITH THE ECONOMICALLY CONSERVATIVE GROUP AMONG CLINTON ADVISERS. HIS WALL STREET LINKS SHOULD COMPLEMENT BENTSEN'S WEIGHT WITH THE CONGRESS.

7. THOSE APPOINTED WILL ATTEND CLINTON'S ECONOMIC SUMMIT IN LITTLE ROCK ON 14-15 DECEMBER, FOLLOWING WHICH WORK WILL BEGIN ON THE ECONOMIC PACKAGE AND NEXT YEAR'S BUDGET. THE COHESION OF THIS TEAM WILL DEPEND ON HOW THE ECONOMIC COUNCIL WORKS. BY APPOINTING A HEAVYWEIGHT CHAIRMAN TO A BODY WITHOUT A CLEAR ROLE, CLINTON HAS CREATED SOME POTENTIAL FOR CONFLICT.

8. CLINTON HAS NOT YET NOMINATED A CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS, FOR WHICH THE CANDIDATES INCLUDE ROBERT REICH, LAURA TYSON (BERKELEY) AND LARRY SUMMERS OF THE WORLD BANK. CLINTON WILL BALANCE THESE MAINLY CONSERVATIVE CHOICES BY APPOINTING LIBERALS TO OTHER POSTS. BUT THERE WILL REMAIN SCOPE FOR CONFLICT BETWEEN BENTSEN, PANETTA AND CO. AND MORE LIBERAL ADVISERS IN THE CLINTON CAMP.

9. THE CLINTON TEAM ARE BEING SUBJECTED TO PRESSURE FROM THE AFL/CIO AND OTHER SPECIAL INTERESTS TO TOUGHEN THE U.S. STANCE ON NON-AGRICULTURAL ISSUES IN THE URUGUAY ROUND (MY TELNO 2707).

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MY TELNO 2606 : U.S. ECONOMY

1. WHEN I SAW GREENSPAN, HE SAID THAT IT WOULD BE UNWISE TO PUT TOO MUCH WEIGHT ON THE THIRD QUARTER FIGURE FOR GDP GROWTH (3.9 PER CENT). AS THE ECONOMY GATHERED SOME MOMENTUM, THERE WOULD BE STATISTICAL UPS AND DOWNS. HE EXPECTED REASONABLY GOOD FOURTH QUARTER RESULTS, BUT WELL SHORT OF THAT RATE OF GROWTH. WHEREAS THREE MONTHS AGO, HOWEVER, HE WAS PREDICTING GDP GROWTH OVER THE YEAR OF BETWEEN 1.5 TO 2 PER CENT, HE WAS NOW CONVINCED THAT GROWTH WOULD BE BETWEEN 2 AND 2.5 PER CENT AND QUITE PROBABLY CLOSE TO THE HIGHER FIGURE.

2. I COMMENTED THAT THIS LEFT THE CLINTON TEAM WITH SOMETHING OF A DILEMMA, GIVEN THAT THEY CONTENDED THAT THE ECONOMY WAS STILL VERY SLUGGISH AND IN NEED OF A FISCAL STIMULUS. GREENSPAN AGREED. HE DID NOT BELIEVE THAT THE CLINTON ADMINISTRATION COULD AFFORD SIMPLY TO CONCLUDE THAT THE RECOVERY WAS UNDER WAY AND NOT MUCH MORE NEEDED TO BE DONE. HE EXPECTED THEM TO COME FORWARD WITH SOME FORM OF INVESTMENT TAX CREDIT BUT HE WAS PRETTY SCEPTICAL ABOUT THE REAL EFFECT OF SUCH MEASURES EXCEPT TO THE EXTENT THAT THEY DID REPRESENT SOME REDUCTION IN OVERALL CORPORATE TAXATION. THERE COULD WELL BE AN R AND D TAX CREDIT AND AN ATTEMPT TO SPEED UP SOME INFRASTRUCTURE SPENDING THOUGH HERE TOO THE HIGHWAYS BILL PASSED EARLIER THIS YEAR ALREADY PROVIDED FOR A SIGNIFICANT ACCELERATION OF SPENDING. GREENSPAN EXPECTED CLINTON TO PROPOSE A MODERATE FISCAL STIMULUS. ANYTHING MORE WOULD CAUSE ALARM IN THE MARKETS ABOUT THE PROSPECTS FOR THE DEFICIT.

3. ON THE DEFICIT GREENSPAN SAID THAT THERE WOULD BE SOME DECLINE OVER THE NEXT THREE OR FOUR YEARS AS GROWTH RESUMED AND THE SAVINGS AND LOAN PROBLEM WAS WORKED THROUGH. BUT ALL THE ANALYSTS AGREED THAT FROM 1995/96 THE DEFICIT WOULD RISE AGAIN UNLESS DETERMINED ACTION WAS TAKEN TO DEAL WITH ENTITLEMENT PROGRAMMES AND, ABOVE ALL, ESCALATING HEALTH CARE COSTS. IT WOULD BE VERY DIFFICULT TO

TACKLE THIS PROBLEM IN THE THIRD OR FOURTH YEARS OF THE CLINTON ADMINISTRATION. MUCH, THEREFORE, WOULD DEPEND ON HOW COURAGEOUS THEY WERE PREPARED TO BE ABOUT PROPOSALS TO REFORM HEALTH CARE IN THE NEXT TWO YEARS.

4. I SAID THAT WE HAD MADE CLEAR TO MOST OF CLINTON'S ECONOMIC ADVISERS OUR VIEWS ON THE TAXATION OF FOREIGN COMPANIES. GREENSPAN SAID THAT HE DID NOT BELIEVE THAT THE NEW ADMINISTRATION WOULD INTRODUCE DISCRIMINATORY LEGISLATION. THERE UNDOUBTEDLY WAS SOME DEGREE OF TAX AVOIDANCE BY FOREIGN CORPORATIONS, AS SOME COMPANIES SOUGHT DELIBERATELY TO HOLD DOWN TAXABLE PROFITS ON THEIR OPERATIONS IN THE UNITED STATES. SO, OF COURSE, DID SOME U.S. COMPANIES.

5. I SAID THAT THE CLINTON TEAM WERE SAYING THAT THEY INTENDED TO PROCEED THROUGH I.R.S. ENFORCEMENT AND WE WERE POINTING OUT TO THEM THAT TAX EVASION THROUGH TRANSFER PRICING ETC WAS A PROBLEM WHICH POTENTIALLY AFFECTED ALL OUR COUNTRIES WHICH SHOULD BE ADDRESSED TOGETHER E.G. IN THE OECD. WE REMAINED CONCERNED ABOUT FURTHER ATTEMPTS AT CONGRESSIONAL LEGISLATION IN THIS AREA. GREENSPAN SAID THAT HE WOULD GO ON MAKING CLEAR THAT, WHILE TAX EVASION TO THE EXTENT IT EXISTED MUST OF COURSE BE DEALT WITH, ANYTHING THAT DETERRED FOREIGN INVESTMENT WOULD BE EXTREMELY DAMAGING TO THE U.S. ECONOMY.

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U.S. ECONOMY

SUMMARY

1. REVISED GDP NUMBERS SHOW STRONG 3.9 PER CENT RATE OF GROWTH IN THIRD QUARTER LATEST. GDP DATA FOLLOW SERIES OF GOOD ECONOMIC INDICATORS. BUT GROWTH AT THIS RATE NOT LIKELY TO BE SUSTAINED.

DETAIL

2. THE COMMERCE DEPARTMENT PUBLISHED TODAY ITS SECOND ESTIMATE OF GDP GROWTH FOR THE THIRD QUARTER OF THIS YEAR. IT SHOWED GROWTH AT A RATE OF 3.9 PER CENT, COMPARED WITH THE FIRST ESTIMATE OF 2.7 PER CENT. THIS IS THE STRONGEST GROWTH RATE SINCE THE FOURTH QUARTER OF 1988, AND WAS MUCH STRONGER THAN ANALYSTS EXPECTED. THE COMPONENTS OF GDP WERE REVISED UPWARDS ACROSS THE BOARD.

3. THESE LATEST DATA COME ON THE HEELS OF A SERIES OF MORE OPTIMISTIC MONTHLY INDICATORS FOR THE US. YESTERDAY IT WAS REPORTED THAT DURABLE GOODS ORDERS ROSE 3.9 PER CENT IN OCTOBER, THE LARGEST INCREASE SINCE JULY 1991. RETAIL SALES ROSE 0.9 PER CENT IN OCTOBER, INDUSTRIAL PRODUCTION ROSE 0.3 PER CENT, AND EXPORTS JUMPED 6.8 PER CENT IN SEPTEMBER. EACH OF THESE WAS STRONGER THAN EXPECTED. THE MOST WIDELY WATCHED INDEX OF CONSUMER CONFIDENCE, PUBLISHED BY THE CONFERENCE BOARD, RECOVERED IN NOVEMBER FROM RECENT LOW LEVELS.

4. REACTING TO TODAY'S DATA, PRESIDENT-ELECT CLINTON HINTED THAT THEY MIGHT AFFECT HIS SHORT TERM PLANS TO BOOST THE ECONOMY BUT OBSERVED THAT THE NUMBERS WOULD NEED TO BE CONSIDERED IN DETAIL FIRST.

5. THERE IS STILL SOME SCEPTICISM AMONG ANALYSTS AS TO WHETHER THE THIRD QUARTER'S RAPID GROWTH WILL BE SUSTAINED INTO THE FOURTH QUARTER. OUTPUT WAS BOOSTED IN THE THIRD QUARTER BY GAINS IN PRODUCTIVITY WHICH WILL NOT NECESSARILY CONTINUE. AND ABOUT HALF OF THE UPWARD REVISION IN GDP WAS DUE TO A CHANGE IN THE ESTIMATE OF STOCKBUILDING. TO THE EXTENT THAT STOCKBUILDING WAS INVOLUNTARY AND NOT SUPPORTED BY STRONGER DEMAND, REDUCTIONS IN STOCKS MAY DEPRESS GDP GROWTH IN THE FOURTH QUARTER.

6. I WILL BE DISCUSSING THESE STATISTICS AND FUTURE PROSPECTS WITH GREENSPAN NEXT WEEK.

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Treasury Chambers, Parliament Street, London, SWIP 3AG
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Prime Minister (C)

23 November 1992

Richard Gozney Esq
Principal Private Secretary to the
Secretary of State for Foreign and
Commonwealth Affairs
Foreign and Commonwealth Office
Downing Street
LONDON
SW1A 2AL

Dear Richard,

ECONOMIC POLICY UNDER PRESIDENT CLINTON

The Chancellor has read with interest your letter of November 5 to Stephen Wall which deals with transition issues before President-elect Clinton takes office.

The Chancellor believes that economic policy will dominate the opening months of the Clinton Administration, and that in turn economic policy concerns will strongly influence other policies. Even though short term prospects for activity in the US look better than in many other European economies, the overriding aim in the US will be to improve on what was widely perceived in the campaign as the very poor economic performance of the past two years.

Nevertheless, the Chancellor believes that budgetary constraints will severely limit President Clinton's scope for stimulating the economy. With US short term interest rates already so low, the Fed is likely to have little if any scope for further monetary relaxation. Indeed an ill-judged budgetary stimulus could weaken bond markets, where long term interest rates have already started to drift up, and bring forward a rise in dollar short term interest rates.

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With this background there is likely to be pressure on the Clinton Administration to offset activity enhancing budgetary measures with cuts elsewhere - most likely in defence - or at least to make such measures strictly time limited. The Chancellor believes that President Clinton may well want to examine closely measures such as the raising of investment allowances for a limited period that the Chancellor announced in the Autumn Statement.

However, the Chancellor is very concerned about President-elect Clinton's proposal during the election campaign that the US Treasury could raise \$45 billion by preventing tax avoidance by foreign corporations. He believes that this issue should be added to the list of transition issues.

When the Chancellor saw Senator Lloyd Bentsen, Chairman of the Senate Finance Committee, and a group of visiting senators at the end of last week he impressed on them that any problem of inadequate payment of corporate taxes by multinational companies needed to be addressed through international cooperation, not unilateral action. The senators appeared to recognise the problems that ill-judged unilateral action would cause. But Senator Bentsen underlined the strength of US feeling on this issue.

There are as yet no details of what President Clinton's Administration is likely to propose. But we understand that the intention may be better enforcement of existing rules, rather than new legislation. And it is highly unlikely that anywhere near \$45 billion over four years could be raised. Nevertheless, this is an issue which the new Congress is likely to get its teeth into and is something of the very first importance to UK economic interests.

HM Embassy Washington in conjunction with the Inland Revenue have for some time been in discreet contact with Clinton's advisers to ensure that the new administration understands UK views on the potentially serious implications of this issue, before any firm policy statement is issued. In fact, IRS figures show that as a percentage of total receipts UK-owned companies in the US paid slightly more tax than US-owned corporations, and substantially more than other non-US owned companies.

The Inland Revenue has decided to establish an inter-departmental working group to coordinate the handling of US tax issues and to provide HM Embassy, Washington with effective briefing. It is important that, at every opportunity UK worries about the proposed tax policy on foreign companies are highlighted.

The Chancellor believes that closer international economic cooperation is needed both for the broad issues of macroeconomic policy and market management and for particular issues like the

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taxing of foreign companies. He looks forward to cooperating with the Clinton economic team, particularly in the context of G7 Finance Ministers' meetings.

I am copying this letter to private secretaries of other Cabinet Ministers, the Governor of the Bank of England, and the Cabinet Secretary.

Yours,
JH

JEREMY HEYWOOD
Principal Private Secretary

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TO IMMEDIATE FCO

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OF 092335Z NOVEMBER 1992

AND TO IMMEDIATE HM TREASURY, BANK OF ENGLAND, INLAND REVENUE
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CLINTON: ECONOMIC POLICY

SUMMARY

1. CLINTON FACING THE DILEMMA OF TRYING TO PROVIDE SOME SHORT-TERM
FISCAL STIMULUS WHILE REASSURING THE MARKETS THAT HE INTENDS TO
DEAL WITH THE DEFICIT IN THE MEDIUM TERM. SOME OF CLINTON TEAM
REASSURING ON TAXATION OF FOREIGN COMPANIES, BUT CONGRESS THE WILD
CARD.

DETAIL

2. CLINTON INHERITS AN ECONOMY WHICH IS PAST THE WORST OF THE
RECESSION. GROWTH IS ANAEMIC BY U.S. STANDARDS. THE HEAD-LINE
UNEMPLOYMENT RATE HAS FALLEN SINCE JUNE FROM 7.8 TO 7.4 PER CENT
BUT OVER-ALL EMPLOYMENT HAS SCARCELY INCREASED. THE DEFICIT IN
FISCAL YEAR 1992 WAS DOLLARS TWENTY-NINE BILLION IE FIVE PER CENT
OF GDP. THE FISCAL PROSPECT ON PRESENT POLICIES WAS FOR SOME
DECLINE IN THE DEFICIT BY 1995 AS THE ECONOMY RECOVERS AND AS THE
SAVINGS AND LOAN BALE OUT IS COMPLETED. BUT SOME OF THE SAVINGS
AND LOAN FINANCE HAS BEEN DEFERRED UNTIL NEXT YEAR: AND ON ALL
ESTIMATES RISING SOCIAL SECURITY AND MEDICARE COSTS WILL WIDEN THE
DEFICIT RAPIDLY AGAIN FROM 1995. THIS WILL CONTINUE TO PUT UPWARD
PRESSURE ON LONG TERM INTEREST RATES AND THREATEN THE RECOVERY.
THE GOOD NEWS IS THAT INFLATION IS LOW AND LIKELY TO REMAIN SO.

3. THE MAIN ISSUE OF THE CAMPAIGN WAS THE ECONOMY. CLINTON'S
PACKAGE INCLUDED HIGHER SPENDING ON CAPITAL PROJECTS, TRAINING AND
THE FAMILY, FINANCED BY EFFICIENCY SAVINGS, FURTHER DEFENCE CUTS
AND HIGHER TAXES ON THE WELL OFF AND FOREIGN CORPORATIONS. BUT THE

COSTINGS ARE UNREALISTIC. THE SPENDING PROPOSALS WILL COST A LOT MORE THAN ESTIMATED, AS WILL HIS PROMISED HEALTH REFORMS. THE PROJECTED SAVINGS ARE INFLATED.

4. CLINTON'S TEAM ARE AWARE OF THIS AND ARE BEGINNING TO RE-WORK THE PROPOSALS. CLINTON INTENDS TO HOLD AN EARLY MEETING WITH BUSINESS LEADERS. HE WILL WANT TO PRESENT HIS FY 1994 BUDGET AS SOON AS POSSIBLE AFTER TAKING OFFICE, AS THE CENTREPIECE OF A RECOVERY PROGRAMME. SOME CLINTON ADVISERS ARE TALKING OF A REVENUE NEUTRAL STIMULATORY PACKAGE, BASED ON ADDITIONAL INVESTMENT INCENTIVES, BRINGING FORWARD INFRASTRUCTURE SPENDING AND DEEPER DEFENCE CUTS. BUT GIVEN THE EXPECTATIONS CLINTON HAS AROUSED, IT WILL BE DIFFICULT TO AVOID A HIGHER DEFICIT NEXT YEAR. IF THIS IS NOT TO BE COUNTER-PRODUCTIVE, IT WILL HAVE TO BE COUPLED TO SOME SORT OF ACTION TO TRY TO DEAL WITH THE DEFICIT IN THE MEDIUM TERM.

5. CONCERN ABOUT THE DEFICIT PROVED TO BE WIDESPREAD IN THE CAMPAIGN. MOST INSIDERS HAD NOT EXPECTED IT TO BECOME A MAJOR CAMPAIGN ISSUE. BUT CLINTON WILL NOW BE AWARE THAT IF NOTHING IS DONE, THIS MAY AFFECT HIS RE-ELECTION PROSPECTS - WITH OR WITHOUT ANOTHER RUN BY PEROT.

6. CLINTON'S HONEYMOON COMBINED PROBABLY WITH SOME MODEST SHORT TERM FISCAL STIMULUS COULD HELP HIM GET CONGRESSIONAL AGREEMENT TO THE SOME MEDIUM TERM DEFICIT REDUCING MEASURES. CONGRESS WILL HAVE TO ADDRESS THE DEFICIT WHEN THE STATUTORY CEILING OF JUST OVER DOLLARS 4 TRILLION TREASURY DEBT IS REACHED IN 1993.

7. IF CLINTON DOES NOT ACT EARLY IN HIS TERM, IT WILL BE MORE DIFFICULT TO DO SO LATER. THE PROSPECT OF MID-TERM ELECTIONS WILL MAKE CONGRESS TIMID AND THE POLITICAL HONEYMOON WILL BE OVER. IN THAT EVENT, THE RESULT COULD BE A DEFICIT OF AT LEAST PRESENT LEVELS AND RISING, WITH HIGHER LONG TERM INTEREST RATES STILL DAMAGING RECOVERY.

TAXATION OF FOREIGN CORPORATIONS

8. THE DOLLARS 45 BILLION ESTIMATED REVENUE FROM CLOSER POLICING OF FOREIGN CORPORATIONS' TAXES HAS BEEN WIDELY QUESTIONED. SEVERAL CLINTON ASSOCIATES HAVE CONTINUED TO TELL US THAT HE WILL NOT PROPOSE NEW LEGISLATION.

9. BUT CLINTON'S EMPHASIS ON THIS IN THE CAMPAIGN WILL ENCOURAGE CONGRESS TO SEEK NEW WAYS OF RAISING MONEY FROM FOREIGN CORPORATIONS. HOUSE WAYS AND MEANS CHAIRMAN ROSTENKOWSKI IS

PLEGDED TO INTRODUCE A REVISED VERSION OF HIS SO-CALLED FOREIGN TAX SIMPLIFICATION BILL IN THE NEXT CONGRESS, AND THIS WILL PROVIDE A VEHICLE. WE HAVE LOBBIED HARD AGAINST THIS LEGISLATION. IT WILL NOW GET A NEW LEASE OF LIFE.

10. IN THIS AS IN OTHER RESPECTS, THERE ARE TENSIONS IN THE CLINTON CAMP BETWEEN ACTIVISTS WHO GENUINELY FAVOUR SOME KIND OF INDUSTRIAL POLICY AND MORE CONSERVATIVE THINKERS WHO WANT TO REFORM SOCIAL SECURITY, UNDERSTAND THE IMPERATIVE NEED TO CONTAIN HEALTH-CARE COSTS (WHICH ALREADY ARE EQUAL TO THIRTEEN PER CENT OF GDP) AND WHOSE IMMEDIATE CONCERN IS NOT TO THREATEN RECOVERY BY SPOOKING THE MARKETS. HOW TO DEAL WITH HEALTH-CARE IS GOING TO BE A MAJOR HEAD-ACHE FOR CLINTON AS HE HAS PROMISED (A) TO EXTEND COVERAGE TO THIRTY MILLION LOWER PAID WORKERS NOT COVERED BY MEDICARE WHILE (B) CONTAINING COSTS.

INTERNATIONAL TRADE

11. CLINTON CAME DOWN IN FAVOUR OF NAFTA, WITH SOME ADD-ONS THAT WOULD NOT AFFECT THE TEXT OF THE TREATY, AND SAYS THAT HE WANTS A QUOTE GOOD GATT AGREEMENT UNQUOTE. IN HIS CAMPAIGN HE SOUNDED A MORE PROTECTIONIST NOTE THAN BUSH AND HE WILL HAVE TO DEAL WITH STRONG DEMOCRATIC PRESSURE GROUPS. IF HE SOUGHT TO RENEW THE FAST-TRACK NEGOTIATING AUTHORITY, GEPHARDT AND CO. WOULD SEEK TO TACK ON A NEW SUPER-301. BUT THE CLINTON CAMP ARE WORRIED ABOUT INHERITING A TRADE WAR. THEY MIGHT CRITICISE BUT WOULD THINK VERY CAREFULLY BEFORE BLOCKING AN AGREEMENT REACHED BY THE OUT-GOING ADMINISTRATION.

TREASURY

12. CLINTON'S WORDS OF REASSURANCE TO THE MARKETS (MY TELNO 2417) SHOW THAT HE UNDERSTANDS THE IMPORTANCE OF RETAINING MARKET CONFIDENCE. HE IS LIKELY TO APPOINT A RESPECTED FIGURE, WITH CREDIBILITY ON WALL STREET, AS TREASURY SECRETARY. DESPITE THE PRESS SPECULATION, IT WOULD BE SURPRISING IF VOLCKER WERE APPOINTED. THAT WOULD TAKE ECONOMIC POLICY OUT OF CLINTON'S HANDS. ONE OF THE SENIOR BANKERS CLOSE TO CLINTON EG ALTMAN, RUBIN OR ROHATYN, OR POSSIBLY, SENATOR BENTSEN, LOOKS A MORE LIKELY CHOICE. BENTSEN IS DUE TO CALL ON THE CHANCELLOR AND FOREIGN SECRETARY IN LONDON ON 13 NOVEMBER.

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AND TO IMMEDIATE TREASURY, BANK OF ENGLAND, ACTOR

U.S. ECONOMY: GREENSPAN'S TESTIMONY

SUMMARY

1. GREENSPAN DESCRIBES PRESENT RECOVERY AS DULL, BUT SEES IT ACCELERATING NEXT YEAR. TARGETS FOR MONEY SUPPLY UNCHANGED. LITTLE MARKET REACTION. STRONG QUESTIONING BY DEMOCRATS.

DETAIL

2. IN HIS TWICE YEARLY HUMPHREY HAWKINS TESTIMONY TODAY, FEDERAL RESERVE BOARD CHAIRMAN ALAN GREENSPAN TODAY TOLD THE SENATE BANKING COMMITTEE THAT THE U.S. RECOVERY WAS DULL. HE SAID THAT THE STRUCTURAL IMBALANCES IN THE ECONOMY, DUE TO THE BUILD UP OF DEBT, WERE MORE SEVERE THAN MANY HAD THOUGHT. BUT A LOT OF PROGRESS HAD BEEN MADE IN REDUCING THESE PROBLEMS, WITH BOTH HOUSEHOLDS AND BUSINESSES REDUCING THEIR DEBT BURDENS SIGNIFICANTLY. HOUSEHOLDS WERE ABOUT HALF WAY THROUGH THIS PROCESS AND BUSINESSES MORE SO. TOGETHER WITH SUCCESSIVE MOVES BY THE FED TO EASE POLICY, IT SHOULD LEAD TO GROWTH OF BETWEEN TWO AND THREE QUARTER AND THREE PER CENT OVER 1993.

3. GREENSPAN DISCUSSED THE RECENT BEHAVIOUR OF THE MONEY SUPPLY. BOTH M2 AND M3 ARE CURRENTLY BELOW THEIR TARGET GROWTH RANGES. AS M2 WEAKNESS WAS ONE OF THE FIRST SIGNS LAST YEAR THAT THE RECOVERY WAS FALTERING, ITS RENEWED WEAKNESS THIS YEAR HAS CAUSED CONCERN.

4. THE FED NOW BELIEVES THAT THE SLUGGISH MONEY SUPPLY REFLECTS A NUMBER OF FACTORS WHICH DO NOT NECESSARILY IMPLY RENEWED ECONOMIC WEAKNESS. THE PUBLIC, FACED WITH VERY LOW INTEREST RATES, HAS MOVED FUNDS INTO ASSETS NOT INCLUDED IN THE BROAD MONEY DEFINITION. PEOPLE HAVE BEEN PAYING OFF DEBT RATHER THAN HOLDING MONETARY ASSETS. AND BANKS, FOR THEIR PART, HAVE BEEN RESTRUCTURING THEIR BALANCE SHEETS AND SO HAVE NOT BEEN AGGRESSIVELY COMPETING FOR DEPOSITS.

5. GREENSPAN STRESSED THE UNCERTAINTY ABOUT INTERPRETING RECENT MOVEMENTS IN THE MONEY SUPPLY, IN THE LIGHT OF WHICH THE FED HAD

DECIDED TO LEAVE ITS TARGETS FOR MONEY SUPPLY GROWTH UNCHANGED. THESE THEREFORE REMAIN AT TWO AND A HALF TO SIX AND A HALF PER CENT FOR M2, AND ONE TO FIVE PER CENT FOR M3.

6. GREENSPAN WAS QUESTIONED AGGRESSIVELY BY SOME OF THE DEMOCRATS, IN PARTICULAR SENATORS SARBANES (D-MD), AND RIEGLE (D-MICH). SARBANES EMPHASISED THE FAILURE OF EMPLOYMENT TO RECOVER AS IT HAD DONE IN PREVIOUS RECOVERIES, ATTACKING THE FED FOR ACTING AS IF THERE WAS NO PROBLEM. RIEGLE SAID THAT THE FED PUT TOO MUCH EMPHASIS ON INFLATION AND NOT ENOUGH ON UNEMPLOYMENT, AND DID NOT APPEAR TO BE GETTING THE MESSAGE THAT THE ECONOMY WAS STILL VERY WEAK. AS A RESULT, THE FED'S POLICY RESPONSE WAS INSUFFICIENT.

7. GREENSPAN REJECTED THESE CRITICISMS. IF THE FED DID NOT BELIEVE THERE WAS A PROBLEM THEY WOULD NOT HAVE EASED INTEREST RATES ON 23 OCCASIONS OVER THE PAST THREE YEARS. SHORT TERM INTEREST RATES HAD BEEN REDUCED BY TWO THIRDS. AND THE DISCOUNT RATE WAS AT A 29 YEAR LOW. RECENT EMPLOYMENT DATA HAD BEEN WORRYING, BUT HE EXPECTED TO SEE SOME UPWARD REVISIONS GROWTH IN THE SECOND QUARTER OF THIS YEAR WOULD PROBABLY BE AROUND 2 PER CENT. THIS WAS SLOWER THAN IN PREVIOUS RECOVERIES, REFLECTING THE STRUCTURAL PROBLEMS THAT HE HAD ALREADY DESCRIBED. BUT THE RECOVERY WOULD SOON AGAIN GAIN MOMENTUM.

COMMENT

8. THERE WAS LITTLE MARKET REACTION TO GREENSPAN'S TESTIMONY, WHICH WAS IN LINE WITH WHAT MANY ANALYSTS ARE NOW SAYING ABOUT THE U.S. ECONOMY. THE DOLLAR BRIEFLY STRENGTHENED ON HIS COMMENT THAT HE SAW NO BENEFIT FROM FURTHER DOLLAR DEPRECIATION. THE DEMOCRATS' STRONG CRITICISMS CAN BE LINKED TO THEIR POLITICAL AGENDA.

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U.S. ECONOMY

SUMMARY

1. FEDERAL RESERVE CUTS DISCOUNT RATE TO 3 PERCENT. RISE IN UNEMPLOYMENT FIGURES FURTHER EVIDENCE OF SLOW AND JERKY RECOVERY. DISCUSSION WITH MEMBERS OF THE FED.

DETAIL

2. FIGURES PUBLISHED TODAY INDICATE A RISE IN UNEMPLOYMENT TO 7.8 PERCENT. THIS MEASUREMENT IS UNRELIABLE AS IT IS BASED ON A TELEPHONE SURVEY. BUT THE STATISTICS ALSO SHOW A DECLINE OF 117,000 IN TOTAL EMPLOYMENT - THE PAY-ROLL FIGURE - WHICH IS MORE RELIABLE. IN RESPONSE TO THIS FURTHER EVIDENCE OF A SLUGGISH AND JERKY RECOVERY, THE FED THIS MORNING CUT THE DISCOUNT RATE TO 3 PERCENT. SEVERAL OF THE COMMERCIAL BANKS HAVE ANNOUNCED A CORRESPONDING CUT IN THE PRIME RATE TO 6 PERCENT.

3. GREENSPAN AND THE OTHER GOVERNORS OF THE U.S. FEDERAL RESERVE BANK, PLUS THE REGIONAL CHAIRMEN OF THE FED, CAME TO DINNER AT THE EMBASSY DURING THEIR TWO DAY MEETING HERE.

4. MULLINS (DEPUTY CHAIRMAN) SAID THAT WHAT WAS TAKING PLACE WAS A SLOW AND JERKY RECOVERY. WHILE INDUSTRIAL PRODUCTION WAS UP, CONSUMER SPENDING HAD FLATTENED OUT AND HOUSING STARTS WERE DOWN. BRADY AND DARMAN ARE PARTICULARLY CONCERNED THAT THE FED CONSISTENTLY HAS BEEN UNDER-SHOOTING ITS ALREADY LOW TARGETS FOR M2. TYPICALLY, THEY CONTEND, WHEN THE M2 FIGURE TURNS DOWN, THIS IS LIABLE TO BE FOLLOWED BY A SLACKENING IN ECONOMIC ACTIVITY 4-6 MONTHS LATER. SOME KEY MEMBERS OF THE FED CONTEST THIS. NONE OF THEM LIKED BEING PUBLICLY ADMONISHED BY THE PRESIDENT, ON THE EVE OF THEIR MEETING, TO LOWER INTEREST RATES. THE MEETING DECIDED, HOWEVER, THAT IF THE PAY-ROLL FIGURE CONFIRMED A SLACKENING IN THE UPTURN, THERE SHOULD BE A FURTHER CUT IN THE DISCOUNT RATE, WHICH HAS NOW BEEN ANNOUNCED.

5. THE PROJECTIONS STILL ARE FOR AN INCREASE IN GDP OF JUST OVER 2

PERCENT THIS YEAR, WITH STRONGER GROWTH NEXT YEAR. BUT THERE ARE WORRIES ABOUT THE VIGOUR OF THE RECOVERY AND SERIOUS REGIONAL PROBLEMS, PARTICULARLY IN CALIFORNIA, WHICH CONTINUES TO BE HIT HARD BY THE DEFENCE CUTS AND WHERE MANY PEOPLE HAVE BORROWED AGAINST OVER-INFLATED PROPERTY VALUES. THE DECLINE IN HOUSING STARTS IN CALIFORNIA HAS BEEN 25 PERCENT. THE STATE OF THE CALIFORNIAN ECONOMY IS EXTREMELY WORRYING TO THE WHITE HOUSE.

6. GREENSPAN AND MULLINS COMMENTED THAT, TECHNICALLY, THE RECESSION ENDED SEVERAL MONTHS AGO. NOR, IN THEIR VIEW, IS THERE REAL DOUBT ABOUT A RECOVERY. BUT THEY ACKNOWLEDGED THAT THERE COULD BE FURTHER DIPS IN A VERY GRADUALLY ASCENDING CURVE.

7. WITH CONSUMER PRICE INFLATION CURRENTLY AT 3.2 PERCENT, THIS LATEST ACTION BY THE FED IS LIKELY TO BE AS FAR AS ANY OF THE GOVERNORS ARE PREPARED TO GO IN SEEKING TO STIMULATE THE ECONOMY THIS SIDE OF THE ELECTION.

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U.S. BALANCED BUDGET AMENDMENT

SUMMARY

1. CONGRESS IS ABOUT TO VOTE ON A CONSTITUTIONAL AMENDMENT REQUIRING A BALANCED BUDGET BY 1997. THE PRESIDENT IS LOBBYING HARD FOR THE AMENDMENT FOR POLITICAL REASONS, BUT IT IS UNLIKELY TO PASS.

DETAIL

2. WHEN I SAW DARMAN ON 11 MAY (MY TELNO 1032) HE MADE CLEAR THAT THE ADMINISTRATION WOULD BE THROWING ITS WEIGHT BEHIND THE ATTEMPT TO ENACT A CONSTITUTIONAL AMENDMENT REQUIRING THE BUDGET TO BE BALANCED BY 1997.

3. THE FEDERAL BUDGET DEFICIT IS EXPECTED TO BE AROUND DOLLARS 350 BILLION IN 1992. IT IS SUPPOSED TO LEVEL OUT AT AROUND DOLLARS 200 BILLION BY 1997, BUT THERE IS SCEPTICISM AS TO WHETHER IN FACT IT WILL DO SO. INTEREST PAYMENTS CURRENTLY ARE RUNNING AT DOLLARS 200 BILLION A YEAR. GREENSPAN HAS BEEN PRESSING HIS VIEW THAT THE DEFICIT IS THE REASON FOR THE PERSISTENTLY HIGH LEVEL OF LONG-TERM INTEREST RATES IN THE U.S.

4. VARIOUS PROPOSALS HAVE COME FORWARD IN CONGRESS FOR A CONSTITUTIONAL AMENDMENT TO REQUIRE THE FEDERAL BUDGET TO BE BALANCED. THE HOUSE WILL VOTE ON A VERSION NEXT WEEK AND THE SENATE WILL VOTE SHORTLY AFTERWARDS. A TWO-THIRDS MAJORITY WOULD BE NEEDED IN BOTH HOUSES, FOLLOWED BY RATIFICATION BY TWO-THIRDS OF THE STATES.

5. CONGRESS IS DIVIDED. SOME SEE THE AMENDMENT AS A GIMMICK WHICH WILL TAKE ATTENTION OFF THE NEED TO AGREE SPECIFIC SAVINGS NOW.

SOME FEAR THAT THE AMENDMENT, IF PASSED, WOULD IMPOSE AN EXCESSIVELY TIGHT STRAIGHTJACKET ON ECONOMIC POLICY MAKING. OTHERS FEAR THAT IT WOULD BE IMPOSSIBLE TO DEVISE SATISFACTORY ENFORCEMENT MECHANISMS. SPEAKER FOLEY AND SENATE MAJORITY LEADER MITCHELL HAVE COME OUT AGAINST THE PROPOSAL.

6. THE PRESIDENT USED A TELEVISED PRESS CONFERENCE LAST NIGHT TO THROW HIS WEIGHT BEHIND THE AMENDMENT. HE SAID THAT FISCAL SANITY NEEDED TO BE RESTORED FOR THE SAKE OF FUTURE GENERATIONS AND THAT ORDINARY PEOPLE WANTED THE AMENDMENT EVEN IF WASHINGTON DID NOT.

7. DARMAN HAS STRESSED THAT THERE WOULD BE SAFEGUARDS TO ENABLE CONGRESS TO OVERRIDE THE AMENDMENT IN EMERGENCIES. HE HAS ARGUED THAT A BALANCED BUDGET CAN BE ACHIEVED THROUGH SPENDING CUTS, NOT TAX INCREASES. BUT HIS FIGURES DEPEND ON OPTIMISTIC ECONOMIC GROWTH ASSUMPTIONS. ALTHOUGH HE STRESSES THAT SOCIAL SECURITY WOULD NOT BE TOUCHED, HIS LIST OF POSSIBLE CUTS HITS HEALTH AND MANY OTHER AREAS OF POLITICALLY SENSITIVE DEMAND-LED SPENDING.

8. A NUMBER OF DEMOCRATS SUPPORT THE AMENDMENT, BUT THEY DIFFER FROM THE ADMINISTRATION ON HOW TO ACHIEVE A BALANCED BUDGET, AS THEY CONTEND THAT TAX INCREASES WILL BE REQUIRED AS WELL AS DEEPER CUTS IN DEFENCE SPENDING.

9. CURRENT EXPECTATIONS ARE THAT THE HOUSE VOTE WILL BE CLOSE, BUT THAT THE SENATE WILL REJECT THE AMENDMENT.

10. THE DEBATE ON THE BALANCED BUDGET AMENDMENT IS A RESULT OF ELECTION YEAR PRESSURES. UNDER ATTACK FROM PEROT THE PRESIDENT HAS TO DEMONSTRATE THAT HE HAS A PLAN FOR DEALING WITH THE DEFICIT. SUPPORT FOR THE AMENDMENT IS A SAFE WAY OF ACHIEVING THIS GOAL, AS HE CAN BE FAIRLY CERTAIN THAT CONGRESS WILL NOT PASS IT. PEROT AND CLINTON WILL CONTINUE TO ATTACK THE PRESIDENT ON THE ISSUE. HE WILL SEEK TO PUT THE BLAME ON THE DEMOCRATS IN CONGRESS FOR FAILING TO PASS THE AMENDMENT. HE POINTS OUT THAT CONGRESS SYSTEMATICALLY HAS BLOCKED MOST OF HIS PROPOSED SPENDING CUTS.

11. THE AMENDMENT IN ANY EVENT IS NO SUBSTITUTE FOR HARD DECISIONS ON CUTTING ENTITLEMENTS AND/OR RAISING TAXES. THE FACT THAT SUCH A MEASURE HAS SUPPORT IN CONGRESS DEMONSTRATES THE FRUSTRATION WITH YEARS OF TRYING TO WRESTLE UNSUCCESSFULLY WITH THE ISSUE. BUT UNTIL THE POLITICAL WILL EXISTS TO TAKE UNPOPULAR DECISIONS, LITTLE PROGRESS IS LIKELY TO BE MADE IN BRINGING THE DEFICIT UNDER CONTROL.

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From the Private Secretary

12 May 1992

Dear Sheila,

VISIT OF ALAN GREENSPAN

Thank you for your letter of 11 May with briefing for Alan Greenspan's call on the Prime Minister. The Chancellor of the Exchequer was present.

US Elections

Mr. Greenspan said that the US election campaign was taking place in the most unusual political environment that he could recall. The fact was that the US was in remarkably good shape globally. The western world had prevailed politically and militarily, and the economy was not doing too badly. It was marginally depressed, but far better than it had been historically. Yet there was no public sense of euphoria or even tranquillity; there was instead a sense of long-term despair. It was as if the traditional enemy (the Soviet Union) had gone, and there was a lack of focus. There was no reason for this despair. The economic outlook was in fact surprisingly buoyant, but in these circumstances it was not surprising that Ross Perot, as the "none of the above" candidate, was doing well. He gave the impression of not knowing where he stood on anything, but it was somehow assumed that he had the capacity to deliver. The general perception was that he would fade as third party candidates had done in the past, and Mr. Greenspan thought that was the likelihood. But in a television age where the potency of party structure was less than it had been, you could not rule out the direct appeal of a television candidate.

The Prime Minister said he had seen a David Frost interview with Mr. Perot. He had formed the impression that Mr. Perot did not know how he would bring about his objectives. Traditionally, about 45 per cent of the electorate did not vote in Presidential elections. To what extent was Perot drawing support from that segment of the population? Mr. Greenspan said that the pollsters tried to adjust for that effect, but he was not sure that it was possible for them to do so. The Prime Minister added that it was hard to believe that President Bush would not win comfortably. Mr. Greenspan thought the President would do rather well. The Yale prediction, which was traditionally accurate, suggested that Bush would get 57 per cent of the vote in a two-person race on the strength of the economy. However, the economy would not necessarily be the dominant issue in this campaign.

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The US economy

The Prime Minister asked whether the US economic recovery was secure. Mr. Greenspan said it would be premature to say that it was secure, but it was showing many good signs. He thought the situation in Britain now was rather like the situation in the United States two or three months ago. He thought very much the same type of forces were at work in the United States, Japan, Northern Europe and Australia. The phenomenon we had faced this time was engendered by large capital gains financed by increases in debt followed by a decline in the market value of collateral. This had led to overloaded balance sheets. The attempt to remedy the situation had led to increased savings and slowed economic activity. He thought Britain and the United States were on different time phases. The US was coming out of recession sooner because they had not been in as deeply especially in the housing/mortgage/consumer spending phenomenon. The rate of economic growth had nonetheless not yet reached critical take-off speed. Things could simmer down again. He did not think they would, but he could not base that belief on any strong reasons. The thinking behind the recent interest rate cut was mainly a form of insurance. Inflationary pressures were muted, and in this type of environment he wanted short-term rates low, but long-term rates even more so. There was a classic element of true deflation in what we had seen. We had not seen major items in the national balance sheet collapse at any other time since the war. The Prime Minister commented that if we did not get accelerating growth it was difficult to see the economy, worldwide lifting from its present difficulties.

Germany

Mr. Greenspan thought the situation in Germany would be quite nasty for the next two years. The Japanese were also in difficulties, but they could not assess the extent of their problems. The USA was in increasingly better shape. You could write a treatise on the crises that hadn't happened over the last five years. We could not look for boom times over the next three years, but by the mid-1980s there was a reasonable expectation that the deflationary process would lead to big improvements in productivity which would sow the seed for accelerated growth. Beyond the next two years, i.e., in the three to six years beyond that, the long-term outlook was better than at any time in the last five to eight years.

The Prime Minister said he could not read the seriousness of the German problems. He wondered how long it would be before the Germans could reduce their interest rates. It was striking that The Times was now arguing that Britain should put its interest rates below those of Germany. The Maastricht Agreement would have some overall impact. Europe had got used to the idea of moving towards European Union. But the motor was no longer quite as certain as it had been.

Mr. Greenspan said that the notion that Britain might reduce its interest rates below those of Germany could suggest that Germany was in far worse shape than anyone imagined. A long-term deterioration would be very destabilising for Europe as a whole.

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- 3 -

He was not sure that there was any profound understanding in Germany of what was happening. There was no doubt that the East German adjustment process was a real albatross round Kohl's neck. The West Germans had failed to grasp how big an issue it would be. The requirement to raise East German wages to West German levels had made it difficult for normal market forces to operate. The fact that East German disposable incomes were about 60 to 65% of those in West Germany meant there had been a transfer from the West. East Germany would go on being a huge drain. The Waigel Budget was basically right, but Greenspan was worried that the Germans would not do what they needed to do. They faced the question of whether they could create a viable East German economy without subsidies. A lot of West German investment was going to Czechoslovakia rather than East Germany for cost and environment reasons. A lot of the boom in construction in East Germany was built on public infrastructure projects. The original estimate of ten years for East German adjustment now looked optimistic.

The Prime Minister wondered whether Waigel could carry out his plans. If East Germany could not succeed with all the West German resources at its disposal, what hope did Russia have? Mr. Greenspan said that Gaidar had been in the USA for several days. He and his colleagues were true capitalists. Much of their suspicion of Gorbachev was based on the belief that Gorbachev was a socialist and they were not. Their commitment to the market economy was very deep, but the Russian culture was alien to market systems. We had always assumed that left to their own devices people would instinctively embrace the market economy. That was no longer so evident. People like ourselves who had centuries of experience of the market dealt with each other in a different way. Much of our behaviour was related to the laws of contract and jurisprudence. These things were not in the genes. You had to create the culture. Russia needed accountants, marketing specialists and auditors who simply did not exist. They were not used to money which had no real purpose in a centrally planned economy. We had no alternative but to dive in and help, but even then the chances of success were not more than 50 per cent. Yevlinsky had recently said to him that the reason why there were so many young people in senior positions was that nobody over 35 could live with change. Gaidar was an able man, but very much at the second or third level. There was nobody of first rank in key positions.

I am copying this letter to Richard Gozney (Foreign and Commonwealth Office) and Paul Tucker (Office of the Governor of the Bank of England).

Tom,
Paul
J.S. WALL

Miss Sheila James,
HM Treasury.

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cc: SJ up

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

11 May 1992

Stephen Wall Esq LVO
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

Prime Minister

Dear Stephen,

[Signature]
11/5

VISIT OF ALAN GREENSPAN

... As requested in your letter of 28 April, I attach briefing for the Prime Minister's meeting tomorrow with Mr Greenspan.

I am copying this letter and attachments to Richard Gozney (FCO) and Paul Tucker (BoE).

Yours,

[Signature]

S M A JAMES

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BRIEF FOR GREENSPAN'S MEETING WITH PM AND CHANCELLOR: 12 MAY

RECENT DEVELOPMENTS IN THE US ECONOMY

Possible points to make on US

- How secure do you think recovery in the US now is? Was the further cut in interest rates in April a sign of nervousness about the sustainability of the recent pick-up in demand?
- In particular, how much should be read into the apparent strengthening of consumer spending in the first quarter? Was it a reflection of one-off factors boosting disposable income? Does a sustained increase in demand require a marked improvement in employment prospects?
- Note that M2 growth remains subdued. Is the Fed happy about the growth of credit - is it high enough to sustain recovery? Have fears of a credit crunch now largely disappeared?
- Real short term interest rates in the US are now close to zero though still just positive. Note that real short rates are higher elsewhere. Is there room therefore, for further easing of interest rates in the US?
- Is the Fed worried about high long rates in the US? Will they produce an unbalanced recovery, dominated by consumption? Or worse, will they stall recovery?

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FURTHER POINTS TO MAKE:

Prospects for G7 growth

- How worried is Greenspan about recovery in world economy as a whole? Note that, once again, forecasts of growth are being revised down. IMF forecasting $1\frac{1}{4}$ per cent G7 growth in 1992 compared with $2\frac{1}{4}$ per cent last autumn. How does Greenspan see G7 growth shaping up over next 18 months? Has continual scaling down of forecasts come to an end?

Japan

- Is the Fed worried about the fall in the Nikkei with its possible impact on bank lending in Japan and possible retrenchment of overseas' holdings by Japanese banks and property companies?
- Does he believe that the Japanese will attempt to meet the $3\frac{1}{4}$ per cent growth target agreed with US?

Germany

- What are Chairman's views on German policy mix? In particular, what are his views on German fiscal stance?
- Is German fiscal looseness likely to persist for some time as a result of unification? Will this cause long term problems for rest of world, particularly in Europe?
- In particular, how concerned is the Fed that tight German monetary policy may stall European growth through high real short term interest rates? And how worried is he that large interest differential between US and Japan on one side and Europe on other is potential source of instability in foreign exchange markets?

Former Soviet Union

- Believe fixed exchange rate for the rouble will provide a nominal anchor for Russian reforms in the context of a strong Fund programme. Anti-inflation strategy also likely to require controls on nominal wages. What are Mr Greenspan's views?

- How does he see the current timetable for the activation of the GAB and establishment of a Rouble Stabilisation Fund?

RECENT DEVELOPMENTS IN THE US ECONOMY

month on month percentage changes

	Nov	Dec	Jan	Feb	Mar	Apr
GDP (quarterly, annualised)		0.4			2.0	

The consumer

Consumer spending	0.7	0.1	1.1	0.8	0.3	
Retail sales (value)	0.0	-0.1	2.1	1.3	-0.4	
Consumer confidence	52.7	52.5	50.2	47.3	56.5	64.8
Non-farm payrolls ('000s)	-230	39	-122	106	39	126

Business

Industrial production	-0.2	-0.6	-0.8	0.5	0.2	
Business confidence	50.1	47.4	47.4	52.4	54.1	51.3
Housing starts ('000s)	1075	1118	1180	1283	1365	

Prices

Consumer prices (o.y.a)	3.0	3.1	2.6	2.8	3.2	
Producer prices (o.y.a)	-0.5	0.0	-0.5	0.4	0.9	

1. **Now a fair degree of consensus that US recovery has started:** retail sales, housing starts, industrial production and business confidence have all shown an upturn in recent months. But strength and durability of upturn still uncertain.

2. GDP grew at an annualised 2 per cent in 1992 Q1 despite significant destocking. However a number of special factors helped to boost disposable income - larger than expected tax refunds, extended unemployment benefits and the introduction of changes which temporarily reduce upfront income tax payments. So, it is still too early to say whether a sustained recovery in the US has started. Continued growth in consumer spending (which was up by an annualised 5 per cent in 92Q1) will probably require a significant upturn in employment, given that

There is little scope for further reductions in the saving ratio or any current sign of rising real wages.

3. The Fed Funds rate was cut by $\frac{1}{4}$ point to $3\frac{1}{4}$ per cent on April 9. By May or June it may have become clearer whether the recovery has been sustained, or whether a further small cut in interest rates may be necessary. Monetary (M2) growth, after picking up at the beginning of the year, has fallen back in recent weeks. Continued weakness would almost certainly prompt another rate cut.

4. Despite falling short rates and inflationary pressures which are under control, long term interest rates have risen since the start of the year. The current steepness of the yield curve reflects market worries both about inflationary pressures in the medium-term and the amount of 'paper' that will need to be absorbed in coming years to fund projected Federal and State deficits. The US administration and Fed are worried by the stubbornly high long rates and feel that this could produce a unbalanced recovery; consumption rising but residential and business investment (including stockbuilding) being held back.

5. The current weakness of activity, with output roughly $3\frac{1}{2}$ per cent below potential, is reflected in consumer and producer prices. Producer prices fell in December and January and in recent months have, on average, been unchanged. Consumer prices also remain under control, although there was an unexpectedly strong rise in March.

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BACKGROUND

Prospects for G7 growthIMF forecasts of growth in G7 industrial countries

		----- 1992 -----	1993
	1991	Oct WEO*	- Current WEO -
US	-0.7	3.0	1.6
Japan	4.4	3.4	2.2
Germany ⁽¹⁾	3.1	2.0	1.3
France	1.3	2.4	1.8
Italy	1.3	2.5	1.6
Canada	-1.0	3.8	2.7
UK	-2.2	2.4	0.8
G7	0.9	2.8	1.7
			3.3

(1) western Germany.

(2) April 6, 1992

* IMF's World Economic Outlook

1. Since the October WEO the IMF have revised down their forecasts of growth in 1992 for every G7 country. The smallest revision is to France (down 0.6 percentage points) and the largest to US (down 1.4 percentage points). For the G7 as a whole, the IMF now forecast growth of 1.7 per cent in 1992 compared with 2.8 per cent last autumn. The FSBR forecast was for G7 growth of only 1½ per cent in 1992. The IMF forecast a strong recovery from the second half of 1992 with growth of 3.3 per cent in 1993.

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BACKGROUND

German Fiscal Policy

1. Our understanding of the estimated outturn for 1991 and projection for 1992 is set out below:

	1991	1992
<u>Public Sector Budget Deficits</u>		
Federal	52	47
Länder and Municipalities	35	47
German Unity and other Funds	<u>33</u>	<u>33</u>
Public sector deficit	120	127
(per cent of GNP)*	(4.4)	(4.2)
Treuhand borrowing	21	31
Public Corporations borrowing	<u>22</u>	<u>29</u>
Wide Public Sector deficit	163	187
(per cent of GNP)*	(6.0)	(6.3)
Memorandum items		
Social Security Fund**	-18	13
General Government deficit***		
(per cent of GNP)*	(3.3)	(3.6)

* Estimated all-German GNP is used as denominator.

** Negative represents a surplus.

*** Figures from IMF WEO

2. In 1992, the IMF forecast that the German general government deficit (3.6 per cent of GNP) will be large but lower than the deficits in the USA (4.7 per cent), Canada (3.9 per cent), Italy (10.4 per cent) and the UK (5.1 per cent). However, the general government deficit does not measure the extent of the German public sector's demands on capital markets. The latter is likely to be a better indicator of the pressures on German long-term interest rates. Looking at wider measures of the German public sector deficit i.e. including Treuhand and public corporations borrowing, it is clear

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that the public sector's demand on capital markets is very substantial indeed. It is probable that the deficit of the German public sector is second only to that of Italy as a percentage of GDP in the G7. Also the continuing high level of capacity utilisation in Germany suggests that most of the deficit is structural rather than cyclical.

3. The Federal government has made determined attempts to control its own borrowing, but there is strong pressure for higher borrowing from other parts of the public sector. This year the borrowing of the eastern German regional and local authorities is set to climb steeply. The central authorities are not in a position to control this borrowing directly. Investment in the infrastructure in eastern Germany is also leading to heavy borrowing by the public corporations, principally the railways and telecommunications.

4. The enormous costs of supporting the east German economy are becoming clear. The Bundesbank has recently estimated that the net costs this year would be DM180bn, over 6 per cent of all German GDP, following DM139bn in 1991. These figures may be compared with projections made in May 1990, immediately prior to unification, of total transfers to the east of DM38bn in 1991 (OECD Survey 1991). The extent of the collapse of east German output and employment, not expected prior to unification, together with the need to replace much of the infrastructure, are the main reasons for these gross underestimates.

5. An idea of the extent to which eastern Germany is dependent on western support is contained in the following estimates:

- eastern GDP is about half total domestic demand;
- 40 per cent of eastern private consumption is financed by transfers from transfers.

Given that the east German labour market has probably not yet bottomed out and that only a fairly modest (10 per cent) increase in east German GDP can be expected this year an early end to high levels of support seems unlikely.

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6. The plan for the Federal budget is for a decline to DM35bn in 1994. If this is to be realized it may require some or all of the following:

- a further rise in taxation;
- more determined cuts in government expenditure, especially subsidies, in the west;
- shifting a greater burden on to the Länder and municipalities.

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BACKGROUND

Japanese Equity Markets

1. Japanese equity prices have now fallen by about 25 per cent since the beginning of this year and by over 50 per cent compared with the 1990 average, itself well below the 1989 peak.

2. Until quite recently the fall in equities could be regarded as a reaction to the speculative bubble in 1989, with only small effects on the real economy - the weakness of business confidence and investment being the most noticeable. The further sharp fall in recent weeks, especially as it is being led by bank shares may have more serious consequences. Japanese banks hold the equity of those companies to which they lend and unrealized capital gains can be counted as part of banks' tier 1 capital for the purposes of the Basle ratios. Equity losses have therefore reduced their tier 1 capital and Japanese banks' capital ratios have now fallen below the 8 per cent Basle threshold as the Nikkei has fallen below about 18,000. This will encourage banks to reduce their loans. In addition, the slowdown in activity and the fall in land prices have increased bad debts, and will add to the pressure for retrenchment by the banks. However in contrast to the position in the US and the UK, Japanese banks remain profitable.

3. There must be a risk, given this credit crunch effect, that growth in Japan this year will be significantly less than the 2½ per cent currently being forecast by the Fund Staff. The main effects on the world economy may mainly come about through retrenchment by Japanese banks and property companies in overseas markets. A reduced willingness to undertake long term investment outside Japan could further depress property prices in such centres as London. But it might also reduce the competitive pressure on local banks, which would be welcome.

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10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

27 April 1992

Dear Treasury,

VISIT OF ALAN GREENSPAN

The Prime Minister has seen a telegram from our Embassy in Washington reporting that Alan Greenspan, the Chairman of the Fed, will be in London on Tuesday 12 May and would like to see him. The Prime Minister has agreed to see Mr Greenspan at 1700 on Tuesday 12 May for forty-five minutes. I should be grateful if the FCO could arrange the meeting, and if you could provide a brief for the Prime Minister to reach me by lunchtime on Monday 11 May. Perhaps you could let me know whether the Chancellor would wish to attend the meeting.

I am copying this letter to Richard Gozney (Foreign and Commonwealth Office) and Paul Tucker (Bank of England).

Jws,
Stephen
J S WALL

J Heywood Esq
HM Treasury

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MELLISS
BANK FOR PS/GOVERNOR

US ECONOMY AND G7 ISSUES

SUMMARY

1. GREENSPAN CAUTIOUSLY OPTIMISTIC ABOUT US ECONOMY. US TREASURY CONFIRMS INTENTION TO PRESS AT G7 FOR FISCAL TIGHTENING IN GERMANY AND FISCAL STIMULUS IN JAPAN.

DETAIL

2. I CALLED ON FED CHAIRMAN GREENSPAN THIS AFTERNOON. WE TALKED MAINLY ABOUT THE US ECONOMY AND TOUCHED BRIEFLY ON THE G7 MEETING. MINISTER (ECONOMIC) SUBSEQUENTLY DISCUSSED G7 ISSUES WITH THE US TREASURY.

3. GREENSPAN SAID THAT GDP GREW IN THE FIRST QUARTER OF 1992 AT AN ANNUAL RATE OF 2 PER CENT. THIS WAS BETTER THAN EXPECTED, DUE TO SEASONAL FACTORS WHICH AFFECTED RETAIL SALES IN PARTICULAR. THE SECOND QUARTER FIGURES WERE LIKELY TO BE CORRESPONDINGLY SOMEWHAT DISAPPOINTING. HOWEVER, ALL THE SIGNS CONTINUED TO SUGGEST A MODEST RECOVERY, EVEN THOUGH THE MARGINS OF ERROR - BOTH UP AND DOWN - WERE MUCH GREATER THAN IN A NORMAL CYCLE. THE RECESSION, AND HENCE THE RECOVERY, WERE HIGHLY UNUSUAL BECAUSE THEY RESULTED FROM PEOPLE AND BUSINESSES PAYING OFF DEBT. THERE HAD BEEN A MARKED LOSS OF CONFIDENCE, PEOPLE WERE STILL VERY CAUTIOUS, AND CONSUMPTION WAS CONSEQUENTLY STILL VERY SLUGGISH. NEVERTHELESS, HE WAS CONSIDERABLY MORE OPTIMISTIC THAN HE HAD BEEN 3-4 MONTHS AGO. I ASKED WHETHER HE ENDORSED A FORECAST BY FED DEPUTY CHAIRMAN MULLINS THAT GDP WOULD BE GROWING AT AN ANNUAL RATE OF 3 PER CENT BY THE THIRD QUARTER. HE DID NOT EXPLICITLY ENDORSE THIS BUT DID NOT DENY IT EITHER.

4. GREENSPAN GAVE TWO REASONS FOR THE RECENT QUARTER POINT CUT IN THE FEDERAL FUNDS RATE TO 3.75 PER CENT. THE MAIN PURPOSE WAS TO COUNTER THE DECLINE IN THE MONEY SUPPLY FIGURES. BUT THE FED ALSO WANTED TO DEMONSTRATE THAT THEIR FOCUS WAS ON INFLATION, NOT ECONOMIC PERFORMANCE. SINCE INFLATION WAS SO WELL UNDER CONTROL, THEY COULD AFFORD TO RELAX INTEREST RATES A LITTLE FURTHER. THE MOVE WAS DEFINITELY NOT TO HELP THE JAPANESE MARKETS : THEY HAD DELAYED ACTION BY 24 HOURS TO AVOID GIVING THAT IMPRESSION.

5. ON LONG-TERM INTEREST RATES, GREENSPAN REPEATED WHAT HE TOLD THE SENATE BANKING COMMITTEE LAST FRIDAY. HE BELIEVED THE MARKETS WERE RELAXED ABOUT INFLATION PROSPECTS OVER THE NEXT 2-3 YEARS. THE STEEP YIELD CURVE REFLECTED CONCERN ABOUT PROSPECTS OVER THE LONGER TERM, PARTICULARLY THE FEDERAL DEFICIT. IT WAS ESPECIALLY WORRYING THAT BOTH THE ADMINISTRATION AND THE CONGRESSIONAL BUDGET OFFICE WERE NOW FORECASTING A CONTINUING UNDERLYING DEFICIT THROUGH THE 1990'S. SENATOR SIMON HAD RECENTLY INTRODUCED A BILL IN THE SENATE PROVIDING FOR A CONSTITUTIONAL AMENDMENT REQUIRING A BALANCED BUDGET. THERE WERE INDICATIONS (GREENSPAN SAID) THAT THIS COULD WIN ENOUGH VOTES TO PASS IN BOTH THE SENATE AND THE HOUSE. IN ANY CASE, IT WOULD ENSURE THAT THE NEED TO REDUCE THE DEFICIT ONCE AGAIN CAME TO THE FOREFRONT OF PUBLIC DEBATE.

6. ON G7 ISSUES, GREENSPAN SAID HE SAW NO LIKELIHOOD OF THE BUNDESBANK REDUCING INTEREST RATES BEFORE THE AUTUMN. HE BELIEVED THAT THE GERMAN FEDERAL GOVERNMENT WAS IN A STATE OF CONFUSION ABOUT FISCAL POLICY AND HAD NOT HANDLED UNIFICATION VERY WELL. HE IMPLIED THAT HE AGREED WITH THE US TREASURY VIEW THAT PRESSURE WAS NEEDED TO SECURE A TIGHTER FISCAL STANCE IN GERMANY.

7. MINISTER (ECONOMIC) SUBSEQUENTLY CALLED ON THE US TREASURY (BARRY NEWMAN). NEWMAN MADE THE FOLLOWING MAIN POINTS ON THE FORTHCOMING G7 MEETING:

A) THE US WOULD PRESS GERMANY TO TIGHTEN FISCAL POLICY, PRIMARILY THROUGH EXPENDITURE REDUCTIONS. THEY HAD NOT YET DECIDED THEIR POSITION ON TAXES - IN PARTICULAR WHETHER TO PRESS FOR CONTINUATION OF THE TEMPORARY TAX SURCHARGE. THE FIRM HOPE WAS THAT FISCAL TIGHTENING WOULD PAVE THE WAY FOR EARLY INTEREST RATE REDUCTIONS IN GERMANY, BUT THERE WOULD BE NO PUBLIC PRESSURE FOR THIS. THE US WOULD PRESS JAPAN FOR A SUBSTANTIAL FISCAL STIMULUS BY THE SUMMER IF NECESSARY, PRIMARILY THROUGH SPENDING INCREASES RATHER THAN TAX CUTS.

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NEWMAN EXPECTED A 5:2 LINE UP ON THESE ISSUES (GERMANY AND JAPAN VERSUS THE REST).

B) AT DINNER ON SATURDAY CAMDESSUS WOULD BE ASKED TO SET OUT HIS THINKING ON THE SIZE OF THE FSU'S FINANCING GAP, AND ON THE STABILISATION FUND INCLUDING THE DEGREE OF COOPERATION NEEDED BETWEEN THE ROUBLE ZONE CENTRAL BANKS. IT WOULD ALSO BE NECESSARY TO AGREE HOW TO HANDLE THE DISCUSSION WITH GAIDAR ON SUNDAY AFTERNOON. THE US WOULD RESTATE ITS OPPOSITION TO AN SDR ALLOCATION AND ITS VIEW THAT ANY PUBLIC TALK ABOUT EITHER THAT OR A TENTH QUOTA REVIEW COULD UNDERMINE THE PROCESS OF GETTING CONGRESSIONAL APPROVAL FOR THE NINTH QUOTA INCREASE.

C) MULFORD WOULD BE WRITING TO G7 DEPUTIES ON 22 APRIL ABOUT THE AGENDA FOR THEIR MEETING ON SATURDAY. HE WOULD PROPOSE THAT EBRD SOFT LOANS SHOULD BE AN ADDITIONAL LUNCHTIME ITEM ON SUNDAY, ALONG WITH EXCHANGE RATES AND GATT FINANCIAL SERVICES. THE US REMAINED FAIRLY RELAXED ABOUT THE LEVEL OF THE DOLLAR AND DID NOT EXPECT EXCHANGE RATES TO BE A CONTENTIOUS ITEM.

RENWICK

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PAGE 3
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BRIEF FOR CHANCELLOR'S MEETING WITH SECRETARY BRADY: 16 APRIL

RECENT DEVELOPMENTS IN THE US ECONOMY

Possible points to make

- How secure do you think recovery in the US now is? Was the further cut in interest rates, last week, a sign of nervousness about the sustainability of the recent pick-up in demand. Note that retail sales dipped back in March and M2 growth has weakened in recent weeks.

- In particular, how much should be read into the apparent strengthening of consumer spending in the first quarter? Was it a reflection of one-off factors boosting disposable income? Does a sustained increase in demand require a marked improvement in employment prospects?

- How significant, if at all, is the jump in headline CPI inflation in March? Note that producer prices remain subdued

- Real interest rates are now close to zero but are still positive. Note that real rates have, after past recessions, gone negative to help generate recovery. On reasonable assumption that inflation will remain around 3 per cent, is there room therefore, for further easing of interest rates?

- How much of recent dollar instability has reflected changing views about the recovery and the future path of interest rates. How much of the strengthening of the dollar since the turn of the year reflects a discounting of future recovery? If clearer signs of recovery emerge in coming weeks how much further do you think/do you want, the dollar to rise?

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NOTE ON RECENT DEVELOPMENTS IN THE US ECONOMY

month on month percentage changes

	Oct	Nov	Dec	Jan	Feb	Mar
<u>The consumer</u>						
Consumer spending	-0.2	0.7	0.1	0.9	0.9	
Retail sales (value)	-0.1	0.0	-0.1	2.1	1.3	-0.4
Consumer confidence	60.1	52.7	52.5	50.2	47.3	54.0
Non-farm payrolls ('000s)	7	-230	39	-122	107	19
<u>Business</u>						
Industrial production	-0.1	-0.2	-0.6	-0.8	0.6	
Business confidence	53.5	50.1	47.4	47.4	52.4	54.1
Housing starts ('000s)	1090	1075	1118	1190	1304	
<u>Trade</u>						
Trade balance (\$bn)	-6.3	-4.2	-6.0	-5.8		
Export volumes	4.7	-0.3	-2.5	-0.5		
<u>Prices</u>						
Consumer prices	0.1	0.4	0.3	0.1	0.3	0.5
o.y.a	2.9	3.0	3.1	2.6	2.8	3.2
Producer prices	0.7	0.2	-0.1	-0.3	0.2	0.2
o.y.a	0.0	-0.5	0.0	-0.5	0.4	

Consumer activity

1. The most interesting feature of recent data has been the pick-up in retail sales and consumer spending in general. This has occurred despite a labour market which remains depressed and despite historically very low levels of consumer confidence. (In February confidence was lower than at any time since 1974.) The value of retail sales in 1992Q1 was 2.9 per cent higher than in 1991Q4 and this has prompted a number of commentators to announce the beginning of a strong US recovery. However, it is probably best to be cautious; the dip in sales in March emphasises the uneven nature of the recovery and there is evidence that a number of special factors boosted disposable income in January and February.

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2. Factors which helped to boost real disposable income at the beginning of the year include larger tax refunds, heavy post-Christmas discounting and unseasonably mild weather (although this beneficial weather effect was reversed in March). However, the change to withholding schedules announced in the President's State of the Union address should begin to take effect shortly and will add around \$2.6 billion a month to disposable income.

3. The effect of all this is that, up to May, there are likely to be signs of a consumer-led recovery underpinned by a series of one-off boosts to disposable income. The real test for the sustainability of the recovery will be when this stream of special factors dries up. At that point, continued growth in consumer spending will require a significant upturn in employment to boost real disposable income and consumer confidence. Without this boost, the historically low level of the saving ratio and the historically high debt-to-income ratio, are likely again to constrain growth. (Unfortunately, the strong rise in non-farm payrolls in February is almost certainly illusory, reflecting problems of seasonally adjusting employment in the retailing sector.)

Other activity indicators

4. Of the other short-term activity indicators, industrial production is not yet on an upward trend although it rose in February as auto production rebounded. However, the business confidence index has picked up strongly and for the past two months has been indicating growth in the manufacturing sector. Housing starts have also picked up.

5. The reliance of the US on a domestically generated recovery is emphasised by the export volume figures. Growth in exports has dried up since November with the slowdown in Europe and Japan. However, Latin America continues to grow strongly and may provide some slight boost to growth.

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6. The current weakness of activity, with output roughly $3\frac{1}{2}$ per cent below potential, is reflected in consumer and producer prices. Producer prices have, on average, been unchanged in recent months. Consumer prices also remain under control although there was an unexpectedly strong rise in March.

Monetary policy

7. The Fed Funds rate was cut by $\frac{1}{4}$ point to $3\frac{1}{4}$ per cent on April 9. This was the first interest rate change since December 20. The main reason for the cut appears to be concern about the (renewed) slow growth of M2. After growing at an annual rate of 5.1 per cent in the three months to February, M2 fell in the last 2 weeks of March. (The Fed's target range for M2 growth in 1992 is $2\frac{1}{2}$ - $6\frac{1}{2}$ per cent.) Despite this further cut in short rates, the 10 year long bond yield remains stubbornly high at $7\frac{1}{4}$ per cent. The cut in short rates does not appear to have been influenced by the weakness of the Japanese stock market.

PETER S CURWEN
IF2 Division
31 March 1992

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BILATERAL WITH SECRETARY BRADY, 16 APRIL: FSU

Line to take

1. Brady's visit to Moscow

- Interested to hear your impressions of Moscow.
Latest news of Congress seems more hopeful.

2. Macro economic assistance for Russia

- Difficult decisions to be made. Financial assistance to Russia inevitably very expensive. West will only have one chance to get it right.
- We therefore need to be reasonably confident that assistance will have right effect before we give it. If we judge that reform process in Russia is being rolled back, may need to put plans on ice.

3. IFC capital increase

- Pleased to note that Congress has now approved Foreign Aid Bill. Hope that US will register its vote in favour of capital increase at earliest

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opportunity. IFC now active in helping privatisation programme in Russia.

4. EBRD: soft loan facility

- Note Attali's idea. But too early to give a definitive response. Need to see details of the proposal.

- At first sight, the FSU states are not candidates for a soft loan facility. Other such facilities (provided by IMF (ESAF) and World Bank (IDA)) benefit countries far poorer than most, and probably all, FSU states. Certainly Russia, at around GDP \$1,900 per head, is well above the ceiling for such facilities. A soft loan facility has obvious implications for policy towards other middle income countries.

- Defence conversion is important. But it is not at all obvious that even if we favoured a soft loan facility, it should be used in this sector.

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Background

Brady's visit to Moscow

1. Brady is on his way back from Moscow, where he was due to meet President Yeltsin.

Macro economic assistance for Russia

2. The outcome of the Congress of People's Deputies appears to leave the Russian government free to implement its reform programmes, at least until the end of the year. Gaidar has indicated that the government will make concessions in a number of important areas, including tax reductions and a loosening of credit policy, which may add to the budget deficit and fuel inflation. The delay in energy price liberalisation (from late April to June) is also significant. There have been a number of Western statements this week (including from Mrs Chalker and Monsieur Attali, both at the EBRD meeting in Budapest) making clear that Western assistance is dependent on progress in implementing economic reform.

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IFC capital increase

3. In June 1991 the IFC's Executive Board agreed to recommend to the Governors that a \$1 billion capital increase be approved to enable the IFC (the private sector arm of the World Bank Group) to continue to expand its activities.

4. The UK has been very much in favour of a substantial capital increase for the IFC as we consider that its work is a valuable part of the World Bank Group's operations and that the increase is urgently needed if the IFC's operations are not to lose momentum.

5. The UK and others including the Germans, French and Japanese cast their votes in favour of the increase later in 1991. The US did not however since it had not secured the approval of Congress. This effectively meant that the capital increase could not go ahead since without the very large US vote insufficient votes had been cast in favour for the increase to be approved.

6. On 1 April 1992 Congress approved a Foreign Aid Bill, which allows the US to vote in favour of the IFC's capital increase. The IFC has yet to receive the formal approval vote from the US, but expect to do so

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over the next week. Once the vote has been received the capital increase will become effective.

EBRD: soft loan facility

7. The idea of a soft loan facility for the FSU was "announced" by M Attali in an interview given to Reuters last week. There was no consultation with EBRD Executive Directors, although there was a discussion with Governors at this week's Annual Meeting (of which we have no details yet). The US are reported to be particularly concerned by the proposals (and the way in which they were launched).

8. The proposal is for a soft loan window to finance infrastructure and longer term projects with a pool of funds to subsidise low market interest rates. Attali is reported to have said that it would be wrong to divert funds from the International Development Association designed for the use of poor countries to the richer middle income countries of Eastern Europe and the FSU and that the funds should be channelled through the EBRD. Attali also said that restructuring of the military complex was not possible with the EBRD's current resources. Cheaper money would be needed as well as bringing in the private sector to match Bank money.

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9. This proposal would lead to a very significant change in the nature of the EBRD, which was established to assist through its loans commercially viable industries in the emerging private sector in its countries of operation.

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FOR COLLINS.

UNITED STATES MONTHLY ECONOMIC REPORT: JANUARY 1992 SUMMARY

SUMMARY

1. PRESIDENT'S BUDGET AND GROWTH PACKAGE ANNOUNCED (SEE MY
TELNOs 201 AND 208). ECONOMY REMAINS WEAK WITH A SHARP FALL IN
EMPLOYMENT IN JANUARY. GRADUAL RECOVERY EXPECTED DURING 1992
MOSTLY IN SECOND HALF OF YEAR.

ACTIVITY

2. GDP FIGURES FOR Q4 1991 SHOWED VERY SLUGGISH GROWTH AT AN
ANNUAL RATE OF 0.3 PER CENT. THIS CONFIRMED THE PICTURE OF AN
ESSENTIALLY FLAT ECONOMY GIVEN BY THE DATA FOR DECEMBER WITH
INDUSTRIAL PRODUCTION DOWN 0.2 PER CENT, RETAIL SALES DOWN 0.4
PER CENT, REAL PERSONAL CONSUMPTION, CONSUMER CONFIDENCE AND
CONSTRUCTION ALL FLAT. THE HOUSING MARKET, WITH STARTS UP 2.6
PER CENT, SHOWED SOME SIGNS OF LIFE. BUT GDP REGISTERED
POSITIVE GROWTH BECAUSE THE STRENGTH OF EXPORTS IN Q4, WHICH
GREW AT A RATE OF OVER 15 PER CENT, MORE THAN OUTWEIGHED A 1.6
PER CENT FALL IN DOMESTIC PURCHASES. INVENTORY INVESTMENT ALSO
EDGED UPWARDS.

3. LOOKING FORWARD, A RECOVERY IN GDP WILL REQUIRE A
STRENGTHENING OF DOMESTIC DEMAND. INVENTORIES ARE LIKELY TO BE
WEAK EARLY IN 1992, AS SOME INVOLUNTARY STOCK ACCUMULATION IN Q4
IS UNWOUND. THE INDEX OF LEADING INDICATORS FELL 0.3 PER CENT
IN DECEMBER AND EMPLOYMENT FELL SHARPLY, BY 91,000, IN JANUARY,

THOUGH THE UNEMPLOYMENT RATE REMAINED UNCHANGED AT 7.1 PER CENT. SO A STRONG EARLY REBOUND IN DOMESTIC DEMAND DOES NOT SEEM LIKELY, AND THERE WILL PROBABLY NOT BE ANY SIGNIFICANT PICK UP IN THE RATE OF GROWTH UNTIL THE SECOND QUARTER WHEN THE EFFECT OF LOW INTEREST RATES AND CONTINUED LOW INFLATION SHOULD BEGIN TO COME THROUGH, LEADING TO A RECOVERY IN CONSUMER CONFIDENCE AND DEMAND FROM THE SPRING ONWARDS. NEVERTHELESS, THERE IS NOT LIKELY TO BE RAPID GROWTH AT ANY STAGE THIS YEAR. THE MOST RECENT CONSENSUS OF FORECASTS - MAINLY PREPARED BEFORE THE PRESIDENT'S GROWTH PACKAGE WAS ANNOUNCED - SHOWS GROWTH OF 1.6 PER CENT IN 1992. THIS COMPARES WITH THE ADMINISTRATION'S FORECAST OF 1.5 PER CENT PUBLISHED IN THE BUDGET, WHICH ASSUMES THAT THE GROWTH PACKAGE IS IMPLEMENTED.

INFLATION

4. DECEMBER'S DATA SHOW THAT INFLATIONARY PRESSURES REMAIN VERY WEAK : CONSUMER PRICES ROSE 3.1 PERCENT THIS YEAR, A CUT IN CAPITAL GAINS TAX AND A CUT OF DOLLARS 27 BILLION IN DEFENCE SPENDING OVER FIVE YEARS. THE PACKAGE SHOULD PROVIDE A MODEST FISCAL STIMULUS IN 1992, MAINLY BY BRINGING FORWARD INVESTMENT AND SPENDING FOR SUBSEQUENT YEARS. BUT THE ADMINISTRATION'S FORECAST THAT IT WILL ADD 0.6 PERCENTAGE POINTS TO GDP GROWTH IN THIS YEAR AND NEXT, AND SMALLER AMOUNTS THEREAFTER, SEEMS OVERSTATED. THE PACKAGE IS NOW BEING CONSIDERED BY CONGRESS.

TRADE DEVELOPMENTS

9. THE TRADE DEFICIT FELL SHARPLY IN NOVEMBER TO DOLLARS 3.6 BILLION FROM 6.3 BILLION IN OCTOBER. THIS REFLECTED CONTINUED STRONG EXPORTS TOGETHER WITH A DOLLARS 2.4 BILLION FALL IN IMPORTS. APART FROM FOOD AND DRINK, ALL MAIN CATEGORIES OF IMPORTS FELL, IN LINE WITH THE WEAKNESS OF DOMESTIC DEMAND. NON-OIL TRADE WAS IN BALANCE, COMPARED WITH A DOLLARS 2.8 BILLION DEFICIT IN OCTOBER.

USE IN RECEIPTS TOGETHER WITH A FALL IN OUTLAYS CUT THE BUDGET DEFICIT TO DOLLARS 2.6 BILLION IN DECEMBER, GIVING A DEFICIT OF DOLLARS 83.2 BILLION IN THE FIRST THREE MONTHS OF FISCAL YEAR 1992.

7. THE PRESIDENT'S BUDGET PUBLISHED IN JANUARY (SEE MY TELNO 208) PROJECTED A DEFICIT FOR FISCAL YEAR 1992 OF DOLLARS 399 BILLION OR 6.7 PER CENT OF GDP. THIS IS SIGNIFICANTLY HIGHER THAN THE PREVIOUS ADMINISTRATION PROJECTION OF DOLLARS 352

BILLION PUBLISHED IN JULY. THE FORECAST ALSO SHOWED A HIGHER DEFICIT IN LATER YEARS, FALLING ONLY GRADUALLY TO 2.3 PER CENT OF GDP BY 1997. EVEN THIS PESSIMISTIC PROJECTION INCLUDES SOME VERY OPTIMISTIC ASSUMPTIONS ABOUT FUTURE EXPENDITURE DLRS AVINGS WHICH ARE UNLIKELY TO BE REALISED.

8. HIGHLIGHTS OF THE PRESIDENT'S GROWTH PACKAGE WERE A DOLLARS 500 PER CHILD ADDITIONAL TAX EXEMPTION TO TAKE EFFECT FROM OCTOBER, A CHANGE TO TAX WITHHOLDING PROCEDURES TO BOOST NET OF TAX PAY NOW AT THE EXPENSE OF SUBSEQUENT REBATES, A US DLRS 5000 TAX CREDIT FOR FIRST TIME HOMEBUYERS FOR HOMES BROUGHT THIS YEAR, AN INVESTMENT TAX ALLOWANCE WHICH ALSO EXPIRES THIS YEAR, A CUT IN CAPITAL GAINS TAX AND A CUT OF DOLLARS 27 BILLION IN DEFENCE SPENDING OVER FIVE YEARS. THE PACKAGE SHOULD PROVIDE A MODEST FISCAL STIMULUS IN 1992, MAINLY BY BRINGING FORWARD INVESTMENT AND SPENDING FOR SUBSEQUENT YEARS. BUT THE ADMINISTRATION'S FORECAST THST IT WILL ADD 0.6 PERCENTAGE POINTS TO GDP GROWTH IN THIS YEAR AND NEXT, AND SMALLER AMOUNTS THEREAFTER, SEEMS OVERSTATED. THE PACKAGE IS NOW BEING CONSIDERED BY CONGRESS.

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US ECONOMY AND BUDGET

SUMMARY

1. CONGRESSIONAL BUDGET OFFICE REPORT FORECASTS MODEST ECONOMIC RECOVERY STARTING IN MIDDLE OF 1992 AND CONTINUING INTO 1993. FEDERAL DEFICIT OF DOLLARS 352 BILLION PROJECTED FOR 1992, 6 PER CENT OF GDP, DROPPING BACK TO AROUND 3 PER CENT OF GDP BY MID-1990S. CBO SAY RECESSION HAS MADE FURTHER DEFICIT REDUCTION INADVISABLE THIS YEAR, BUT DEFICIT SHOULD RETURN TO TOP OF POLITICAL AGENDA IN 1993.

BACKGROUND

2. THE CBO PROVIDES BIPARTISAN ADVICE TO CONGRESS AND ISSUES 6 MONTHLY ECONOMIC AND BUDGET FORECASTS. THE ADMINISTRATION WILL RELEASE ITS OWN FORECAST WITH THE BUDGET PROPOSALS ON 29 JANUARY, THE DAY AFTER THE STATE OF THE UNION ADDRESS.

ECONOMIC OUTLOOK

3. THE CBO FORECAST IS IN LINE WITH MANY ANALYSTS' VIEWS. IT SHOWS YEAR ON YEAR REAL GDP GROWTH OF 1.6 PER CENT IN 1992 AND 3.6 PER CENT IN 1993, COMPARED WITH BLUE CHIP CONSENSUS FORECASTS OF 1.6 AND 3.3 PER CENT. 1991 GDP GROWTH IS ESTIMATED AT MINUS 0.8 PER CENT. CONSUMER PRICE INFLATION IS PROJECTED AT 3.3 PER CENT IN 1992 AND 3.6 PER CENT IN 1993. UNEMPLOYMENT IS PUT AT 6.8 PER CENT IN 1992 AND 6.4 PER CENT IN 1993. FROM 1994, GDP IS EXPECTED TO GROW AT 2.6 PER CENT, COMPARED WITH AN ESTIMATED POTENTIAL GROWTH RATE OF 2.1 PER CENT.

4. CBO DIRECTOR REISCHAUER IS REPORTED IN TODAY'S WASHINGTON POST AS SAYING THAT THE FORECAST QUARTERLY PATH OF GDP IN 1992 SHOWS GROWTH AT AN ANNUAL RATE OF 0.9 PER CENT IN Q1, 2.9 PER CENT IN Q2, 3.4 PER CENT IN Q3 AND 3.9 PER CENT IN Q4.

5. THE CBO ATTRIBUTES THE WEAKNESS OF THE ECONOMY IN THE SECOND HALF OF 1991 TO THREE FACTORS. FIRST, THE FAILURE OF CONSTRUCTION TO PICK UP DUE TO THE OVERHANG OF VACANT COMMERCIAL PROPERTY. SECOND, THE STRONG PICK UP IN IMPORTS RATHER THAN DOMESTIC PRODUCTION WHEN DEMAND GREW IN LATE SPRING AND EARLY SUMMER. THIRD, THE COLLAPSE IN CONSUMER CONFIDENCE CAUSED BY CONTINUED NEWS OF JOB LOSSES AND DECLINING PERSONAL INCOMES. AS A RESULT, PRODUCERS PLANNED FURTHER REDUCTIONS IN OUTPUT AND INVENTORIES LATE IN 1991.

6. THE IMMEDIATE PROSPECTS ARE FOR THESE DEVELOPMENTS TO CONTINUE TO HAMPER GROWTH IN EARLY 1992. BUT WHILE THE WEAKNESS OF CONSUMER CONFIDENCE RAISES THE POSSIBILITY OF A DOUBLE DIP LIKE THAT SEEN IN MID-1981, THE CBO DOES NOT BELIEVE THE COMPARISON WITH THE PREVIOUS RECESSION IS APPROPRIATE. IT POINTS TO THE GRADUAL EASING OF MONETARY POLICY OVER THE PAST TWO YEARS, AND THE LOW INFLATIONARY PRESSURES WHICH WILL HELP KEEP INTEREST RATES LOW. SO THE FORECAST IS FOR VERY SLOW GROWTH IN EARLY 1992 WITH A STRONG REBOUND IN THE SPRING AS INTEREST SENSITIVE SECTORS BEGIN TO RESPOND TO MONETARY POLICY. THE CBO SUGGESTS THAT FINANCIAL LIBERALISATION AND THE ABSENCE OF A FISCAL STIMULUS HAVE DELAYED THAT RESPONSE SO FAR.

7. IN A PASSAGE ON THE CREDIT CRUNCH, THE REPORT SAYS THAT OUTSIDE NEW ENGLAND AND THE MID-ATLANTIC REGION, THE EVIDENCE THAT BANKS HAVE BEEN RESTRAINING CREDIT IS INCONCLUSIVE. IT SUGGESTS THAT SLOW CREDIT GROWTH MAY ALSO REFLECT DEMAND FACTORS, AS BOTH HOUSEHOLDS AND BUSINESSES HAVE BEEN REPAIRING THEIR BALANCE SHEETS AFTER THE DEBT EXPLOSION OF THE 1980S. BUT THE CURRENT WEAKNESS IN CREDIT MARKETS AND THE DEBT HANGOVER SHOULD NOT IN THEMSELVES IMPEDE RECOVERY. THE PROBLEM IS MORE LIKELY TO BE WEAK INCOME GROWTH.

BUDGET DEFICIT

8. THE CBO FORECASTS A RECORD DEFICIT OF DOLLARS 352 BILLION IN FISCAL YEAR 1992 (OCTOBER 1991-OCTOBER 1992). THIS IS 6 PER CENT OF GDP. THE DEFICIT WOULD FALL TO DOLLARS 178 BILLION BY 1996 (2.4 PER CENT OF GDP), BUT RISE AGAIN THEREAFTER, REACHING 4 PER CENT OF GDP BY 2002. THESE PROJECTIONS ARE MORE PESSIMISTIC THAN THOSE

ISSUED BY THE CBO SIX MONTHS AGO, BECAUSE OF MORE GLOOMY ECONOMIC ASSUMPTIONS AND REVISED TECHNICAL ESTIMATES, MAINLY OF TAX REVENUES.

9. THE PROJECTIONS FOR THE NEXT FIVE YEARS ARE :

	1992	1993	1994	1995	1996
AUGUST 1991 ESTIMATE	362	278	234	157	156
CURRENT ESTIMATE	352	327	260	194	178
CURRENT ESTIMATE AS PER CENT OF GDP	6.0	5.2	3.9	2.8	2.4

10. CBO POINT OUT THAT

- A) THE UNDERLYING DEFICIT (EXCLUDING DESERT STORM AND THE COST OF THE THRIFT BAIL OUT) FLUCTUATES LESS, BUT REMAINS AT A WORRYING 3 PER CENT OF GDP FOR MOST OF THE 1990S.
- B) THERE IS A STRONG DANGER OF THE DEFICIT RISING YET FURTHER IF STRICT BUDGET DISCIPLINES ARE NOT MAINTAINED. CBO'S PROJECTIONS ASSUME THAT THE SPENDING CAPS IN THE BUDGET AGREEMENT FOR 1990-95 WILL HOLD. THAT REQUIRES VERY STRINGENT BUDGETING IN THE NEXT THREE YEARS, WHEREAS CURRENT POLITICAL PRESSURES ARE FOR TAX REDUCTIONS AND/OR SPENDING INCREASES. DEFENCE REDUCTIONS MAY NOT BE ENOUGH TO OFFSET ALL THESE COMPETING DEMANDS.
- C) FISCAL MEASURES WILL DO LITTLE TO HELP REVIVE THE ECONOMY IN 1992, BUT COULD SPEED THE RATE OF RECOVERY IN LATE 1992 AND 1993.

11. CBO CONCLUDE THAT QUOTE THE DEFICIT SHOULD RETURN TO THE TOP OF THE POLITICAL AGENDA IN 1993 UNQUOTE.

COMMENT

12. THIS REPORT WILL HAVE AN IMPORTANT INFLUENCE ON CONGRESSIONAL OPINION JUST BEFORE THE PRESIDENT'S GROWTH PACKAGE PROPOSALS ON 28 JANUARY. IT GIVES OUT A SOMEWHAT EQUIVOCAL MESSAGE, STRESSING ON THE ONE HAND THE DANGERS OF RELAXING BUDGET DISCIPLINES AND

INCREASING THE DEFICIT : YET ALSO IMPLYING THAT CERTAIN FISCAL MEASURES COULD HELP TO STIMULATE ECONOMIC REVIVAL AND MIGHT TAKE PRECEDENCE OVER DEFICIT REDUCTION THIS YEAR.

13. THERE IS A GROWING ACCEPTANCE IN THE ADMINISTRATION AND CONGRESS THAT THE DEFICIT MAY INDEED NEED TO BE INCREASED FURTHER IN 1992 AND 1993 TO PAY FOR TAX CUTS, OFFSET BY FURTHER DEFENCE SAVINGS MAINLY IN LATER YEARS. THAT BREAKS AN ESSENTIAL PRINCIPLE OF THE BUDGET AGREEMENT : THAT TAX CUTS OR SPENDING INCREASES MUST BE BALANCED BY OFFSETTING MEASURES WITHIN THE YEAR IN QUESTION. IT IS A PITY THAT THE CBO HAS NOT SPELT OUT THE DANGERS OF GOING DOWN THIS PATH MORE STRONGLY.

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U.S. ECONOMY

SUMMARY

1. FEDERAL RESERVE CUTS THE DISCOUNT RATE TO 3.5 PER CENT - LOWEST SINCE 1964. GREENSPAN TRYING TO JUMP-START THE ECONOMY. THIS QUITE DRAMATIC MOVE IS AIMED AT RESTORING CONSUMER CONFIDENCE WEAKENED BY THE DEBT OVER-HANG.

DETAIL

2. THE FEDERAL RESERVE BANK CUT THE DISCOUNT RATE THIS MORNING BY A FULL PERCENTAGE POINT FROM 4.5 TO 3.5 PER CENT. THIS TAKES THE RATE DOWN TO THE LOWEST LEVEL SINCE 1964.

3. THIS QUITE DRAMATIC ACTION HAS BEEN TAKEN IN RESPONSE TO THE INCREASINGLY CLEAR EVIDENCE OF A FLAGGING ECONOMIC RECOVERY AND TO WARD OFF THE DANGER OF A DOUBLE-DIP RECESSION. THE LATEST INDICATORS SHOW A DECLINE IN INDUSTRIAL PRODUCTION, WITH THE AUTOMOBILE INDUSTRY IN PARTICULAR IN SEVERE TROUBLE. GENERAL MOTORS HAVE ANNOUNCED THE RETRENCHMENT OF 74,000 EMPLOYEES AND THE CLOSURE OF 21 PLANTS ACROSS THE COUNTRY OVER THE NEXT THREE YEARS.

4. GREENSPAN TOLD ME THIS AFTERNOON THAT THIS WAS THE MOST DIFFICULT PERIOD OF ECONOMIC FORECASTING HE HAD EXPERIENCED AT ANY TIME IN HIS CAREER. INFLATION WAS DOWN TO 3 PER CENT AND FALLING. BUT AFTER THE LIMITED RECOVERY IN THE MIDDLE OF THE YEAR, THE ECONOMY HAD STAGNATED. UNEMPLOYMENT WAS NOT AT HISTORICALLY HIGH LEVELS (IT CURRENTLY IS RUNNING AT 6.8 PER CENT) BUT IT WAS

AFFECTING THE MIDDLE CLASS MORE. THE RESULT OF UNCERTAIN EMPLOYMENT PROSPECTS PLUS UNPRECEDENTED PERSONAL INDEBTEDNESS AND WEAK REAL ESTATE VALUES WAS TO DEPRESS PERSONAL CONSUMPTION. THE FED'S LATEST ACTION WAS QUITE DRAMATIC, BUT HAD BEEN CAREFULLY CALCULATED. HE WAS PLEASED THAT MORGAN GUARANTY HAD RESPONDED IMMEDIATELY BY CUTTING THEIR PRIME LENDING RATE BY A FULL POINT TO 6.5 PER CENT. THE OTHER BANKS WERE STILL HESITATING OVER HOW FAR TO GO, BUT MORGAN'S DECISION WOULD HAVE AN IMPORTANT EFFECT.

5. IN TAKING THIS STEP GREENSPAN HAS BEEN CONSCIOUS OF THE DIFFICULTY THE ADMINISTRATION CONTINUES TO FACE IN DEVISING WORTHWHILE MEASURES OF ITS OWN. THE PRESIDENT HAS CONTINUED TO CONSULT HIS PRINCIPAL ADVISERS ABOUT THE KIND OF GROWTH PACKAGE HE HOPES TO UNVEIL IN HIS STATE OF THE UNION MESSAGE IN JANUARY. HE IS CERTAIN TO PROPOSE CUTS IN THE CAPITAL GAINS TAX AND IS LOOKING AT THE POSSIBILITY OF OTHER TAX AND INVESTMENT CREDITS. BUT HE KNOWS THAT WHATEVER PROPOSALS THE ADMINISTRATION MAKES WILL NOT BE PASSED BY THE DEMOCRAT-CONTROLLED CONGRESS IN THE FORM HE WANTS THEM. WITH A 360 BILLION DOLLAR DEFICIT PROJECTED FOR NEXT YEAR, THERE IS LITTLE SCOPE FOR ANY REAL FISCAL STIMULUS.

6. IN HIS TESTIMONY THIS WEEK TO CONGRESS, GREENSPAN WARNED AGAINST ANY STIMULATORY ACTION THAT WOULD INCREASE THE DEFICIT AND OF THE CRUCIAL NEED TO DEAL WITH THE STRUCTURAL DEFICIT IN THE FEDERAL BUDGET IN THE MEDIUM TERM. HE POINTS OUT THAT THE 360 BILLION DOLLAR DEFICIT EXPECTED IN 1992 IS INFLATED BY THE BAIL-OUT OF THE S AND L'S. THE UNDERLYING FIGURE IS CLOSER TO DOLLARS 200 BILLION. HIS CONCERN IS THAT INSTEAD OF USING PART OF THE REDUCTIONS IN DEFENCE SPENDING TO REDUCE THE DEFICIT, ALL THE CONGRESSIONAL PRESSURES WILL BE DIRECTED TOWARDS TRANSFERRING THEM TO OTHER SPENDING PROGRAMMES. GREENSPAN DOES, HOWEVER, FAVOUR A CUT IN THE CAPITAL GAINS TAX AND THE POSSIBILITY OF LIMITED TAX CONCESSIONS TO HELP SUSTAIN REAL ESTATE VALUES.

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MY TELNO 2888: U.S. ECONOMY

1. I HAD A FURTHER TALK WITH GREENSPAN ABOUT THE ECONOMIC PROSPECTS HERE. HE SAID THAT THE REDUCTION OF THE FEDERAL DISCOUNT RATE TO FOUR AND A HALF PER CENT HAD BROUGHT THE PRIME LENDING RATE DOWN TO SEVEN AND A HALF PER CENT. WITH INFLATION STABLE AT UNDER FOUR PER CENT, THE BASIC FRAMEWORK HAD BEEN ESTABLISHED FOR A RECOVERY IN CONSUMER SPENDING. AMERICA WAS COMING OUT OF THE RECESSION, THOUGH GROWTH IN THE FOURTH QUARTER WOULD NOT BE AS STRONG AS IN THE THIRD: HENCE THE ACTION THE FED HAD TAKEN TO PROVIDE SOME FURTHER STIMULUS. BUT THERE STILL WAS A LACK OF CONSUMER CONFIDENCE: PEOPLE WERE PARTICULARLY WORRIED ABOUT POOR EMPLOYMENT PROSPECTS, DUE TO THE LOSS OF A LOT OF HIGH VALUE JOBS IN THE INSURANCE, BANKING AND DEFENCE INDUSTRIES. CONGRESS WOULD NOT BE ABLE TO PASS A NEW TAX PACKAGE IN THE LEGISLATIVE TIME REMAINING THIS YEAR. GIVEN THE NATURE OF THE PACKAGE THAT WAS LIKELY TO EMERGE, THAT WAS A GOOD THING (SENATOR LUGAR COMMENTED TO ME SEPARATELY THAT THE BEST THING CONGRESS COULD DO WAS TO LEAVE TOWN AND GO FISHING). GREENSPAN ACKNOWLEDGED THAT THERE PROBABLY WOULD BE ATTEMPTS BY BOTH THE ADMINISTRATION AND THE DEMOCRATS IN THE NEW YEAR TO PRODUCE COMPETING GROWTH PACKAGES. THE OUTCOME OF SUCH A PROCESS WOULD BE UNLIKELY TO REASSURE THE BUSINESS COMMUNITY. ACTION ON INTEREST RATES MEANWHILE HAD BEEN TAKEN AS FAR AS IT SAFELY COULD BE.

2. THE CHAIRMAN OF THE FORD MOTOR COMPANY, POLING, WAS MORE BEARISH THAN GREENSPAN ABOUT THE PROSPECTS, AS FORD'S FOURTH QUARTER SALES HAVE BEEN STAGNATING.

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TERENCE BURNS, WICKS, SEDGWICK. BANK OF ENGLAND FOR GREEN.

GREENSPAN AND BOSKIN ON US ECONOMY

SUMMARY

1. BOTH GREENSPAN AND BOSKIN SUGGEST US RECESSION HAS PROBABLY
BOTTOMED OUT. CREDIT AVAILABILITY STILL SEEN AS POTENTIAL
DAMPER ON RECOVERY. EARLY RISE IN US INTEREST RATES HIGHLY
UNLIKELY.

DETAIL

2. CHAIRMAN GREENSPAN (FEDERAL RESERVE) AND CHAIRMAN BOSKIN
(COUNCIL OF ECONOMIC ADVISERS) TESTIFIED ON 17 AND 18 JUNE
RESPECTIVELY TO THE HOUSE WAYS AND MEANS (TAX) COMMITTEE
REGARDING US COMPETITIVENESS, TOUCHING ON EACH OCCASION ON THE
CURRENT STATE OF THE US ECONOMY. THIS PROVIDED A GOOD READ-OUT
ON THE ADMINISTRATION'S VIEWS ON THE LATEST BULLISH ECONOMIC
DATA. (THE FED AND CEA BETWEEN THEM ACCOUNT FOR ALL THE SERIOUS
ECONOMIC FORECASTING CONDUCTED WITHIN THE ADMINISTRATION.)
3. BOTH GREENSPAN AND BOSKIN JUDGE THE RECESSION TO HAVE
BOTTOMED OUT IN THE LAST COUPLE OF MONTHS. THE CEA IS DUE TO
RELEASE AN UPDATE OF ITS BUDGET ECONOMIC FORECAST IN JULY AND,
ACCORDING TO BOSKIN, THERE WILL BE ONLY MINOR REVISIONS: SECOND
QUARTER GROWTH IS EXPECTED TO BE POSITIVE BUT MODEST, WHILE
EXPANSION IN THE SECOND HALF IS PROJECTED AT AN
(ANNUALISED) RATE OF 2 TO 3 PER CENT. GREENSPAN WAS CAUTIOUSLY
OPTIMISTIC: ALTHOUGH HE DID NOT YET SEE A QUOTE MEASURABLE
UPWARD THRUST UNQUOTE, THE DATA WAS QUOTE INCREASINGLY
IMPRESSIONING IN THAT RESPECT UNQUOTE.
4. HOWEVER, WHILE WELCOMING THE EARLY SIGNS OF RECOVERY, BOTH
GREENSPAN AND BOSKIN EXPRESSED RESERVATIONS ABOUT WHETHER THE
SUPPLY OF CREDIT WILL PROVE ADEQUATE DURING THE UPTURN.
GREENSPAN ARGUED THAT THE FED DOES NOT QUOTE SEE ANY TURN OR
MARKED EASING IN THE CREDIT CRUNCH, ALTHOUGH THE EVIDENCE THAT
WE DO HAVE CLEARLY SUGGESTS THAT ITS NOT GETTING WORSE UNQUOTE.
BOSKIN NOTED THAT THIS, ALONG WITH THE FACT THAT IT HAD BEEN A

RELATIVELY MILD RECESSION, WAS THE REASON THE CEA WERE FORECASTING ONLY A MODEST RATE OF RECOVERY.

5. COINCIDENT WITH THESE HEARINGS NEW ECONOMIC DATA WAS RELEASED SUPPORTING THE VIEW THAT THE ECONOMY IS IN THE EARLY STAGES OF RECOVERY. IMPORTS ROSE SIGNIFICANTLY IN APRIL, AND AUTHORISATIONS FOR NEW HOME CONSTRUCTION, WHICH HAVE NOW RISEN FOR FOUR CONSECUTIVE MONTHS, STOOD 22 PER CENT HIGHER IN MAY THAN IN JANUARY.

COMMENT

6. THE ADMINISTRATION, IN COMMON WITH MANY US ANALYSTS, PROJECTS ONLY A MODEST ECONOMIC UPTURN DURING THE SECOND HALF OF THE YEAR. THIS CONTRASTS SHARPLY WITH EVIDENCE FROM EARLIER RECESSIONS WHERE THE SHORT TERM BOUNCE-BACK HAS INVARIABLY BEEN STRONG (AT A 5 TO 6 PER CENT RATE).

7. VARIOUS POLITICAL AND ECONOMIC FACTORS ACCOUNT FOR THIS CAUTION. IN THE CASE OF THE ADMINISTRATION, A MODEST FORECAST MINIMISES THE MARGIN FOR A POLITICALLY EMBARRASSING ERROR ON THE DOWNSIDE. EQUALLY, THEY PROBABLY FEEL THAT TALK OF A STRONG RECOVERY NOW COULD ALLOW THE FED TO MOVE EARLIER RATHER THAN LATER TO RAISE INTEREST RATES. FOR THE FED, AS WITH THE ADMINISTRATION, THERE ARE STRAIGHTFORWARD CONCERNS ABOUT THE ADEQUACY OF BANK CREDIT.

8. GIVEN RESIDUAL CONCERNS ABOUT THE CREDIT CRUNCH, AND A NATURAL CAUTION IN INTERPRETING THE RECENT ECONOMIC DATA, IT IS HIGHLY UNLIKELY THAT THE FED WILL MOVE IN THE NEAR FUTURE TO RAISE US INTEREST RATES, EVEN THOUGH THERE IS A HIGH PROBABILITY THAT THE UPSWING HAS BEGUN AND THAT, ON PAST EVIDENCE, IT COULD BE STRONG.

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FOR GREEN.

UNITED STATES MONTHLY ECONOMIC REPORT: MAY 1991 SUMMARY
SUMMARY

1. MOUNTING EVIDENCE OF NASCENT ECONOMIC RECOVERY, WHICH MAY HAVE BEGUN AS EARLY AS APRIL. SHARE PRICES AND DOLLAR RISE IN RESPONSE. LITTLE CHANCE OF FURTHER FED EASING. AUTHORITIES APPARENTLY RELAXED ABOUT LEVEL OF DOLLAR.
ACTIVITY AND INFLATION
2. A MONTH AGO VARIOUS INDICATORS HINTED AT A BOTTOMING OUT AND POSSIBLE IMPROVEMENT IN US ECONOMIC CONDITIONS. HOWEVER, THESE SIGNS WERE TENTATIVE AND BY NO MEANS UNIVERSAL. DURING MAY, THE PICTURE APPEARS TO HAVE CLEARED, WITH PUBLICATION OF A CLUTCH OF RELATIVELY UPBEAT INDICATORS. ON THE EVIDENCE AVAILABLE, THE ECONOMY MAY HAVE RESUMED EXPANSION AS EARLY AS APRIL. IF SO, THE EIGHT-MONTH CONTRACTION WAS RELATIVELY BRIEF (RECESSIONS HAVE LASTED 11 MONTHS ON AVERAGE OVER THE POST-WAR PERIOD).
3. NUMEROUS INDICATORS ARE NOW CONSISTENT WITH THE START OF AN ECONOMIC UPTURN. THE FOLLOWING ARE A SELECTION: NEW STATE UNEMPLOYMENT BENEFIT CLAIMS HAVE BEEN ON A DOWNWARD TREND FOR 9 WEEKS, AND IN MID-MAY STOOD ALMOST 20 PER CENT LOWER THAN THE LATE MARCH PEAK: EMPLOYMENT ROSE AN ESTIMATED 70 THOUSAND IN MAY, WITH THE FIRST NET INCREASE IN MANUFACTURING EMPLOYMENT FOR 14 MONTHS: SURVEY EVIDENCE FOR MAY POINTED TO THE FOURTH CONSECUTIVE MONTHLY IMPROVEMENT IN INDUSTRIAL CONDITIONS: AND

HOUSING SALES ROSE FOR THE THIRD CONSECUTIVE MONTH IN APRIL.

4. DESPITE THESE SIGNS, HOWEVER, THE CORNER HAS ONLY JUST BEEN TURNED. FOR EXAMPLE, CONSUMERS SURVEYED IN MAY REPORTED THAT JOBS, RATHER THAN EASIER TO FIND, WERE IN FACT SEEN AS INCREASINGLY SCARCE. THE AGGREGATE STATISTICS TELL THE SAME STORY, WITH THE RATE OF UNEMPLOYMENT IN MAY RISING TO NEW PEAK LEVELS. AND REAL PERSONAL DISPOSABLE INCOME ARE ESTIMATED TO HAVE FALLEN IN APRIL. THESE INDICATORS ARE LIKELY TO FALL INTO LINE IN DUE COURSE, BUT IT MAY TAKE SEVERAL MONTHS OF GROWTH FIRST.

5. IF, AS EXPECTED, THE ECONOMY STRENGTHENS FURTHER, ATTENTION WILL TURN TO THE OUTLOOK FOR INFLATION. THE RECORD SO FAR IS MIXED. RATES HAVE COME DOWN FROM PEAK LEVELS IN LATE 1990, BUT REMAIN ABOVE PRIOR AVERAGES. FURTHER REDUCTIONS REMAIN AN ACT OF FAITH, BASED ON LOW OUTTURNS IN MARCH AND APRIL, AND THE HISTORIC FACT THAT US INFLATION GENERALLY FALLS LATE IN THE RECESSIONARY CYCLE. FORECASTERS EXPECT CURRENT CONSUMER PRICE INFLATION OF 4.9 PER CENT (APRIL) TO EDGE DOWN TO 4.5 PER CENT FOR THE YEAR AS A WHOLE.

FINANCIAL MARKETS AND MONETARY POLICY

6. STRONGER THAN EXPECTED ECONOMIC INDICATORS PRODUCED A RALLY IN US SHARE PRICES IN LATE MAY, WITH MARKET INDICES REACHING RECORD LEVELS IN EARLY JUNE. MARKET PARTICIPANTS SUSPECT THAT THE FED IS NOW VERY UNLIKELY TO LOWER INTEREST RATES AGAIN. (INDEED, IN RETROSPECT, THE REDUCTIONS IN THE DISCOUNT RATE AND THE FEDERAL FUNDS RATE IN LATE APRIL WERE PROBABLY OTIOUSE, AND MAY HAVE TO BE REVERSED LATER THIS YEAR.) BOND PRICES FELL, POTENTIALLY SIGNALLING RESURGENT CONCERNS ABOUT INFLATION.

7. WE UNDERSTAND THAT DEPITE THE LATEST RISE IN THE DOLLAR (UP 3.6 PERCENT IN TWO WEEKS AGAINST THE DMARK) US AUTHORITIES ARE RELAXED ABOUT ITS CURRENT LEVEL.

TRADE DEVELOPMENTS

8. TRADE STATISTICS, WHICH ARE LESS TIMELY THAN OTHER INDICATORS, HAVE JUST BECOME AVAILABLE FOR THE MONTH OF MARCH. HERE, WHEN THE ECONOMY WAS PROBABLY CLOSE TO ITS WEAKEST, THE TRADE DEFICIT WAS JUST 4 BILLION DOLLARS, LESS THAN HALF THE LEVEL OF A YEAR EARLIER. HOWEVER, AS DOMESTIC DEMAND RECOVERS THE RECENT FAVOURABLE TREND IN THE DEFICIT MAY WELL BE REVERSED.

FEDERAL BUDGET DEVELOPMENTS

9. THE DEFICIT ON THE FEDERAL BUDGET FOR THE CURRENT FISCAL YEAR (ENDING OCTOBER) IS NOW LIKELY TO BE SOMEWHAT LOWER THAN THE 318 BILLION DOLLARS FORECAST BY THE ADMINISTRATION IN FEBRUARY. BUDGET DIRECTOR DARMAN NOW ESTIMATES THAT THE OUTTURN WILL BE BELOW 300 BILLION DOLLARS, REDUCED BY A FAILURE TO PROCEED WITH BANK AND THRIFT CLOSURES AS RAPIDLY AS PLANNED, AND LOWER MILITARY COSTS THAN EXPECTED (DUE TO GULF WAR CONTRIBUTIONS FROM ALLIES). HOWEVER, BOTH FACTORS ARE TEMPORARY, AND THE FISCAL YEAR 1992 DEFICIT IS LIKELY TO BE CORRESPONDINGLY HIGHER.

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SPRING MEETINGS : THE UNITED STATES ECONOMY
SUMMARY

1. THE CHANCELLOR MAY WELCOME A SNAPSHOT OF THE US ECONOMY AS SEEN FROM HERE.
2. IT IS STILL GENERALLY EXPECTED THAT THE ECONOMY WILL MOVE OUT OF RECESSION BY AUTUMN, THOUGH THERE ARE AS YET NO VERY POSITIVE SIGNS OF RECOVERY. THE EQUITY MARKET HAS BEEN STRONG. THE DOLLAR IS STRENGTHENING STEADILY, THOUGH THIS OWES SOMETHING TO THE FED'S RELUCTANCE TO REDUCE INTEREST RATES FURTHER. THERE ARE CONTINUING CONCERNS ABOUT THE HEALTH OF THE BANKING SECTOR. DETAIL : (A) ECONOMIC PERFORMANCE
3. A WAVE OF OPTIMISM AND RENEWED CONSUMER CONFIDENCE SWEEPED THE COUNTRY IMMEDIATELY AFTER THE GULF WAR. MORE REALISTIC EXPECTATIONS HAVE NOW SET IN. NEVERTHELESS, MOST FORECASTERS ARE STILL PREDICTING MARGINAL OVERALL GROWTH IN GDP FOR 1991, FOLLOWED BY A STRONGER RECOVERY IN 1992 (THE AVERAGE OF PRIVATE SECTOR FORECASTS IS FOR GDP GROWTH OF 2.6 PER CENT IN 1992).
4. THERE ARE A NUMBER OF GROUNDS FOR OPTIMISM. INTEREST RATES (AROUND 6.3 PER CENT AT THE SHORT END OF THE MARKET) ARE AT THEIR LOWEST SINCE THE LATE 1970'S. OIL PRICES HAVE FALLEN BACK TO JUST UNDER DOLLARS 20 A BARREL. CONSUMER PRICE INFLATION, BENEFITING FROM THE OIL PRICE FALL, IS DOWN TO 4.9 PER CENT (FROM 6.3 PER CENT IN NOVEMBER) THOUGH THE UNDERLYING RATE EXCLUDING FUEL AND ENERGY IS FLAT. ANALYSTS EXPECT FURTHER PRICE FALLS LATER IN THE YEAR AS INDUSTRY BENEFITS FROM LOWER ENERGY COSTS. ALSO REFLECTING LOWER OIL PRICES, THE TRADE GAP NARROWED IN FEBRUARY TO DOLLARS 5.3 BILLION - THE LOWEST MONTHLY FIGURE SINCE 1983. THE HOUSING MARKET IS SHOWING SIGNS OF BOTTOMING OUT IN SOME REGIONS. MEANWHILE, CONGRESS IS ABOUT TO AGREE A BUDGET RESOLUTION WHICH KEEPS DISCRETIONARY SPENDING

WITHIN THE LIMITS AGREED LAST AUTUMN. THERE IS TALK OF THE BUDGET DEFICIT FOR THE YEAR ENDING SEPTEMBER 1991 COMING IN SLIGHTLY UNDER THE FORECAST OF DOLLARS 300 MILLION.

5. ON THE MORE GLOOMY SIDE, RECENT OPINION POLLS REPORT THAT CONSUMER CONFIDENCE HAS SAGGED SINCE THE IMMEDIATE POST WAR PERIOD. THERE WAS A FURTHER RISE IN UNEMPLOYMENT IN MARCH TO 6.8 PER CENT, AND A CONTINUED FALL IN INDUSTRIAL PRODUCTION (DOWN 3.3 PER CENT ON MARCH 1990). A NUMBER OF THE MAJOR NEW YORK BANKS, INCLUDING CITICORP AND MANUFACTURERS HANOVER, HAVE JUST REPORTED FURTHER FALLS IN PROFITS. HOWEVER, THE SIGNALS ARE MIXED. UNEMPLOYMENT AND BANKING FIGURES ARE GENERALLY THE LAST TO REFLECT ECONOMIC RECOVERY, WHILST THE ACTUAL FALL IN INDUSTRIAL PRODUCTION IN MARCH WAS THE SMALLEST FOR SIX MONTHS.

6. OUR OVERALL VIEW IS THAT THE RECESSION HAS PROBABLY STARTED TO BOTTOM OUT, AND WILL CONTINUE TO DO SO DURING THE SUMMER. WE ARE NOT HOPEFUL OF A VERY DRAMATIC RECOVERY: ARGUABLY THAT IS NOT DESIRABLE IN ANY CASE SINCE IT COULD FUEL INFLATION. BUT THE PROSPECTS FOR A GRADUAL RETURN TO GROWTH BY 1992 SEEM GOOD.

(B) INTEREST RATES AND THE DOLLAR

7. THERE HAVE BEEN A NUMBER OF MEDIA REPORTS RECENTLY OF DISPUTES IN THE FED ABOUT INTEREST RATES, WITH GREENSPAN ALLEGEDLY FAVOURING SOME FURTHER EASING, WHILST THE REGIONAL FED GOVERNORS WERE MORE CONCERNED TO HOLD DOWN INFLATION. THE FED SIGNALLLED ON 12 APRIL THAT IT WAS NOT PLANNING FURTHER INTEREST RATE CUTS IN THE IMMEDIATE FUTURE AND THIS HAS CALMED SPECULATION. THE ADMINISTRATION ON THE OTHER HAND IS STILL CONCERNED ABOUT THE DANGER OF CONTINUED RECESSION - EVIDENT IN ITS RAPID MOVES TO SETTLE THE RAIL STRIKE LAST WEEK - AND SEEMS TO BE LESS CONCERNED ABOUT THE INFLATIONARY EFFECTS OF LOWER INTEREST RATES.

8. THE DOLLAR HAS BEEN STEADILY GAINING AGAINST BOTH THE YEN AND EUROPEAN CURRENCIES SINCE FEBRUARY. THIS REFLECTS RENEWED INTERNATIONAL CONFIDENCE IN THE US ECONOMY AND A MORE BUOYANT STOCK MARKET, AS WELL AS THE PSYCHOLOGICAL REACTION TO THE GULF VICTORY. RECENTLY THE FED'S SIGNALS ON INTEREST RATES HAVE BEEN A FACTOR.

CONCLUSION

9. THE ADMINISTRATION IS STILL JUMPY ABOUT THE PERFORMANCE OF THE ECONOMY, AND CAN BE EXPECTED TO PUT FURTHER PRESSURE ON THE FED TO EASE INTEREST RATES.

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UNITED STATES MONTHLY ECONOMIC REPORT: FEBRUARY 1991 SUMMARY

SUMMARY

1. ECONOMY STILL IN RECESSION, THOUGH STOCK MARKET OPTIMISTIC
AND CONSUMERS SLIGHTLY LESS GLOOMY. ADMINISTRATION STILL
BETTING ON RESUMED GROWTH BY SECOND HALF OF YEAR. DOWNSIDE
RISKS ASSOCIATED WITH DEPRESSED REAL ESTATE MARKET AND POTENTIAL
CREDIT SHORTAGES.

ACTIVITY AND INFLATION

2. THE LATEST ECONOMIC STATISTICS, FOR THE MONTH OF FEBRUARY,
SHOW THE ECONOMY STILL IN RECESSION. UNEMPLOYMENT ROSE TO 6.5
PER CENT (FROM 6.2 PER CENT IN JANUARY) AND EMPLOYMENT FELL A
LARGER THAN EXPECTED 184 THOUSAND. AUTO SALES REMAINED
DEPRESSED (DOWN 20 PERCENT RELATIVE TO A YEAR EARLIER) AND THE
WIDELY QUOTED NAPM INDEX OF INDUSTRIAL ACTIVITY CONTINUED TO
SIGNAL CONTRACTING INDUSTRIAL OUTPUT. COMING AFTER SIMILAR
SIGNS OF ECONOMIC CONTRACTION IN JANUARY, THESE INDICATORS
VIRTUALLY CONFIRM THAT THE US IS SET TO RECORD TWO SUCCESSIVE
QUARTERS OF OVERALL ECONOMIC DECLINE.

3. HOWEVER, THERE ARE GROUNDS FOR OPTIMISM, ALBEIT TENTATIVE.

SURVEY EVIDENCE ON BOTH CONSUMER CONFIDENCE AND BUSINESS CONDITIONS SUGGEST A SMALL RECOVERY IN FEBRUARY FROM TROUGH LEVELS A MONTH EARLIER. AND HOUSEHOLDS' PURCHASE PLANS (LOOKING AHEAD UP TO SIX MONTHS) ARE AT THEIR MOST BUOYANT LEVEL SINCE SEPTEMBER. IN ADDITION, WHILE SURVEYS OF RETAIL BUSINESS DO NOT YET SHOW ANY UPTURN IN SPENDING SOME AUTO RETAILERS AND HOME SELLERS ARE REPORTING INCREASED PURCHASER INTEREST.

4. THESE LATENT SIGNS OF ECONOMIC RECOVERY ARE IN LINE WITH THE ADMINISTRATION'S EXPECTATIONS OF A BRIEF, MILD RECESSION. FED CHAIRMAN GREENSPAN, TESTIFYING TO CONGRESS ON 6 MARCH, SAW THE QUOTE LIKELIHOOD OF A PICKUP IN AGGREGATE DEMAND OVER COMING MONTHS UNQUOTE. HOWEVER, THE SITUATION REMAINS UNCERTAIN. GREENSPAN ADMITTED TO DOWNSIDE RISKS FROM THE DEPRESSED PROPERTY MARKET (HOUSE PRICES FELL 4 PER CENT IN REAL TERMS IN 1990) AND FROM BANKS' RELUCTANCE TO EXTEND NEW CREDIT. MOREOVER, GIVEN THAT THE RECESSION HAS TAKEN HOLD, IT IS NOT CLEAR HOW RAPIDLY ECONOMIC CONFIDENCE WILL BOUNCE BACK FOLLOWING THE END OF THE GULF WAR.

5. ALTHOUGH INFLATION IS WIDELY FORECAST TO FALL TO AROUND 4 PER CENT, THE LOWEST RATE SINCE 1986, THE TREND, SO FAR, HAS REMAINED CONSIDERABLY HIGHER. CONSUMER PRICES, EXCLUDING VOLATILE FOOD AND ENERGY PRODUCTS, ROSE 5.6 PER CENT OVER THE YEAR TO JANUARY, THE HIGHEST ANNUAL RATE SINCE THE 1980S. (AND OVER THE THREE MONTHS TO JANUARY, PRICES ROSE AT A 6.2 PER CENT ANNUALISED RATE). THE MOST OPTIMISTIC SIGNAL COMES FROM EMPLOYMENT COSTS, THE RISE OF WHICH MODERATED SOMEWHAT IN THE FOURTH QUARTER. OVERALL, HOWEVER, THE CASE FOR A SIGNIFICANT REDUCTION OF INFLATION IS NOT PROVEN.

TRADE DEVELOPMENTS

6. THE MERCHANDISE TRADE DEFICIT NARROWED TO 6.3 BILLION DOLLARS IN DECEMBER. OVER HALF OF THE IMPROVEMENT RELATIVE TO A MONTH EARLIER WAS IN THE UNDERLYING NON-OIL DEFICIT. THIS LOW OUTTURN, RECENTLY MATCHED ONLY IN JUNE 1990, SUGGESTS THAT THE DECLINE IN THE DEFICIT CONTINUES, DESPITE HAVING TEMPORARILY STALLED IN MID 1990.

MONETARY POLICY AND INTEREST RATES

7. MONETARY POLICY REMAINED ON HOLD THROUGH FEBRUARY. POTENTIAL SIGNS OF ECONOMIC RECOVERY, COMBINED WITH CHAIRMAN GREENSPAN'S GUARDED OPTIMISM, HAVE PERSUADED MARKETS THAT FURTHER NEAR TERM EASING IS UNLIKELY.

8. THIS, TOGETHER WITH PERCEPTIONS OF SLOWING GROWTH IN CONTINENTAL EUROPE AND JAPAN, PROBABLY ACCOUNTS FOR A MODEST FIRMING OF THE DOLLAR. HAVING FALLEN FOR EIGHT SUCCESSIVE MONTHS AGAINST THE DM, THE DOLLAR STAGED A 2 PER CENT RECOVERY IN FEBRUARY.

FINANCIAL MARKETS

9. RESPONDING TO CONCERNS ABOUT BANKS' RELUCTANCE TO EXTEND NEW CREDIT, STEPS TO REDUCE REGULATORY IMPEDIMENTS HAVE BEEN ANNOUNCED. AN IMPORTANT CHANGE WAS WITH REGARD TO THE ACCOUNTING TREATMENT OF TROUBLED LOANS. THE NEW GUIDELINES EMPHASIZE THAT VALUATIONS SHOULD BE BASED ON THE ABILITY OF THE COLLATERAL TO GENERATE CASH FLOW OVER TIME, AND NOT UPON ITS IMMEDIATE LIQUIDATION VALUE. THIS MAY EASE THE CAPITAL SITUATION OF BANKS WITH CONCENTRATIONS OF TROUBLED LOANS.

BUDGET

10. THE ADMINISTRATION'S BUDGET PROPOSALS, RELEASED ON 4 FEBRUARY, WERE CLOSELY IN LINE WITH THE DISCRETIONARY SPENDING TOTALS AGREED WITH CONGRESS IN LATE 1990. HOWEVER, BECAUSE OF A DETERIORATION IN THE ECONOMIC OUTLOOK, AND THE IMPACT OF THIS ON DEPOSIT INSURANCE COSTS, THE FEDERAL DEFICIT IS EXPECTED TO RISE TO RECORD LEVELS OF US DOLLARS 318 BILLION THIS YEAR AND DOLLARS 281 BILLION NEXT.

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BANK FOR GREEN

US EXCHANGE RATE POLICY

SUMMARY

US TREASURY SIGNALS RELUCTANCE TO SEE FURTHER FALL IN DOLLAR.
DETAIL

2. US TREASURY TODAY RELEASED THIRD ANNUAL REPORT ON
INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY (COPY BY BAG TO
MELLISS). MAIN CONCLUSIONS ARE :

(1) FURTHER ADJUSTMENT OF EXTERNAL IMBALANCES SHOULD RELY
PRIMARILY ON MACRO-ECONOMIC AND STRUCTURAL POLICY MEASURES,
RATHER THAN ON FURTHER EXCHANGE RATE ADJUSTMENT.

(2) KOREA STILL MAINTAINS PERVASIVE FOREIGN EXCHANGE AND
CAPITAL CONTROLS AND IMPLEMENTS THEM AGGRESSIVELY. TAIWAN
ALSO AN OFFENDER BUT TO LESSER EXTENT.

3. BARRY NEWMAN, RECENTLY-APPOINTED TREASURY DEPUTY ASSISTANT
SECRETARY FOR INTERNATIONAL MONETARY AFFAIRS, TOLD US TODAY THAT
CONCLUSION (1) WAS A DELIBERATE SIGNAL THAT THE ADMINISTRATION
DOES NOT WISH TO SEE THE DOLLAR FALL FURTHER. BRADY HAD INSERTED
A SIMILAR SENTENCE IN A RECENT SPEECH ON BANKING REFORM BUT IT
WAS NOT PICKED UP BY THE PRESS.

4. REPLYING TO A QUESTION, NEWMAN COMMENTED THAT INCREASING
INTEREST RATES IN ORDER TO SUPPORT THE DOLLAR WAS CLEARLY OUT OF
THE QUESTION. INDEED HE FAVOURED A FURTHER REDUCTION IN INTEREST
RATES. QUOTE THE ONLY ANSWER UNQUOTE WAS THEREFORE AN EASING IN
EUROPE.

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US EXCHANGE RATE POLICY

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HELLO). MAIN CONCLUSIONS ARE:
(1) FURTHER ADJUSTMENT OF EXTERNAL IMBALANCES SHOULD RELY
PRIMARILY ON MACRO-ECONOMIC AND STRUCTURAL POLICY MEASURES
RATHER THAN ON FURTHER EXCHANGE RATE ADJUSTMENT.
(2) KOREA STILL MAINTAINS PERSISTENT FOREIGN EXCHANGE AND
CAPITAL CONTROLS AND IMPLEMENTS THEM AGGRESSIVELY. TAIWAN
ALSO AN OFFENDER BUT TO LESSER EXTENT.
2. BARRY NEWMAN, RECENTLY-APPOINTED TREASURY DEPUTY ASSISTANT
SECRETARY FOR INTERNATIONAL MONETARY AFFAIRS, TOLD US TODAY THAT
CONCLUSION (1) WAS A DELIBERATE SIGNAL THAT THE ADMINISTRATION
DOES NOT WISH TO SEE THE DOLLAR FALL FURTHER. BRADY HAD INSERTED
A SIMILAR SENTENCE IN A RECENT SPEECH ON BANKING REFORM BUT IT
WAS NOT PICKED UP BY THE PRESS.
3. REPLYING TO A QUESTION, NEWMAN COMMENTED THAT INCREASING
INTEREST RATES IN ORDER TO SUPPORT THE DOLLAR WAS CLEARLY OUT OF
THE QUESTION. INDEED HE FAVOURED A FURTHER REDUCTION IN INTEREST
RATES. QUOTE THE ONLY ANSWER UNQUOTE WAS THEREFORE AN EASING IN
EUROPE.

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FM WASHINGTON

TO IMMEDIATE FCO

TELNO 2653

OF 312355Z OCTOBER 90

AND TO IMMEDIATE TREASURY, BANK OF ENGLAND, DTI, INLAND REVENUE
INFO IMMEDIATE OTTAWA, BONN, PARIS, ROME, TOKYO, ACTOR

TREASURY FOR PS/CHANCELLOR, WICKS, ALLAN, MRS LOMAX, CULPIN
MRS M BROWN
BANK FOR GREEN
DTI FOR HAGESTADT
INLAND REVENUE FOR HOUGHTON, FAWCETT, CAYLEY

MY TELNO 2603 : US BUDGET DEFICIT
SUMMARY

US BUDGET DEFICIT LEGISLATION ENACTED ON DEMOCRATIC VOTES.
SIGNIFICANT NEW BUDGET ENFORCEMENT MEASURES INCORPORATED.
SHORT-TERM OUTLOOK IS FOR CONTINUING HIGH DEFICITS BECAUSE OF
ECONOMLC DOWNTURN AND HIGH THRIFT EXPENDITURE. LONGER-TERM
OUTLOOK FOR SIGNIFICANT DEFICIT REDUCTION MORE FAVOURABLE THAN
FOR MANY YEARS.

DETAIL

2. BUDGET DEFICIT LEGISLATION PASSED THE HOUSE BY 228 TO 200
AND THE SENATE BY 54 TO 45. IN BOTH HOUSES, A MAJORITY OF
REPUBLICANS VOTED AGAINST, LEAVING THE PACKAGE TO BE CARRIED ON
DEMOCRATIC VOTES. THE OVERALL SAVINGS ACHIEVED BY THE
LEGISLATIVE PACKAGE HAVE NOT YET BEEN RELEASED, BUT OMB HAVE
SHOWN US THEIR PRELIMINARY ASSESSMENT :

	DEFICIT REDUCTIONS			DOLLARS BILLION	
	FY91	FY92	FY93	FY94	FY95
BASELINE DEFICIT	294	306	227	116	85
REVENUE INCREASES	21	32	30	34	32
ENTITLEMENT SAVINGS	10	17	21	24	24
DISCRETIONARY SAVINGS	10	23	35	53	62
TOTAL SAVINGS	43	78	98	129	144
NEW BASELINE DEFICIT	254	228	129	-13	-59
REVISED TARGETS	205	197	169	112	64

REVISED TARGETS EXCLUDE THRIFTS AND SOCIAL SECURITY

3. THE MAIN MEASURES CONTRIBUTING TO THE DEFICIT REDUCTIONS
ARE:

- 1) SUBSTANTIAL REDUCTIONS IN DEFENCE PERHAPS AMOUNTING TO
20 PER CENT IN REAL TERMS BY 1995.

- 2) MODEST CUTS IN MEDICARE (HEALTH CARE FOR THE ELDERLY).
 - 3) INCREASES IN INCOME TAX FOR HIGH EARNERS.
 - 4) GAS TAX INCREASE OF 5 CENTS A GALLON.
 - 5) ALCOHOL AND TOBACCO TAXES.
 - 6) INCREASED SOCIAL SECURITY AND MEDICARE TAXES.
4. AS WELL AS AGREEING THE MAIN MEASURES TO REDUCE THE DEFICIT, CONGRESS HAS ENACTED A NEW BUDGET ENFORCEMENT MECHANISM TO REPLACE THE OLD GRAMM RUDMAN LAW. THE MAIN FEATURES OF THIS ARE :
- A) AS WITH THE EXISTING GRAMM RUDMAN LAW, WHERE PLANNED EXPENDITURE EXCEEDS SET TARGETS, AUTOMATIC SPENDING CUTS WILL BRING EXPENDITURE BACK INTO LINE. HOWEVER UNLIKE GRAMM RUDMAN, THE CUTS WILL BE CONCENTRATED IN THE CATEGORY OF EXPENDITURE WHERE FORECAST EXCEEDS TARGET.
 - B) ANY POLICY CHANGE WHICH INCREASES EXPENDITURE OR REDUCES REVENUE MUST BE ACCOMPANIED BY AN OFFSETTING POLICY CHANGE TO BRING EXPENDITURE AND/OR REVENUE BACK TO TARGET - QUOTE PAY AS YOU GO UNQUOTE.
 - C) DEFICIT TARGETS WILL BE AMENDED TO TAKE ACCOUNT OF THE LATEST AGREEMENT AND TO EXCLUDE SOCIAL SECURITY AND THRIFT EXPENDITURES.
 - D) IF FUTURE ECONOMIC AND TECHNICAL ASSUMPTIONS DIFFER FROM THOSE UNDERLYING THE BUDGET AGREEMENT, THE DEFICIT TARGETS WILL BE AUTOMATICALLY CHANGED - IE THERE IS NO REQUIREMENT FOR POLICY ACTION TO OFFSET UNPLANNED INCREASES IN THE DEFICIT.
5. THE ECONOMIC ASSUMPTIONS UNDERLYING THE BUDGET DEFICIT AGREEMENT ARE SET OUT BELOW. ALSO SHOWN ARE EQUIVALENT FORECASTS MADE BY INDEPENDENT FORECASTERS.

	(PER CENT CHANGES)					
	90	91	92	93	94	95
GNP GROWTH:						
ADMINISTRATION	0.7	1.3	3.8	4.1	3.7	3.5
INDEPENDENT	0.6	1.5	2.6	2.7	2.7	2.5
INFLATION :						
ADMINISTRATION	5.2	4.6	3.4	3.2	3.0	2.8
INDEPENDENT	5.2	4.6	4.1	4.0	4.0	3.9
SHORT INTEREST RATES :						
ADMINISTRATION	7.7	7.2	5.7	4.9	4.4	4.2
INDEPENDENT	7.6	7.0	6.9	6.9	6.9	6.8
LONG INTEREST RATES :						
ADMINISTRATION	8.7	8.3	7.1	6.1	5.6	5.3
INDEPENDENT	8.7	8.2	N/A	N/A	N/A	N/A

6. THE DEFICIT OUTTURN FOR FY90 WAS DOLLARS 220.4 BILLION - APPROXIMATELY DOLLARS 100 BILLION ABOVE THE FY91 FORECAST ISSUED IN JANUARY. THE MAIN REASONS FOR THE DETERIORATION ARE INCREASED EXPENDITURE ON THE THRIFT INDUSTRY AND A POORER THAN FORECAST ECONOMIC PERFORMANCE. A NUMBER OF UNEXPLAINED FACTORS HAVE ALSO PUSHED UP THE DEFICIT, INCLUDING INCREASED TAKE UP OF SOCIAL PROGRAMMES.

7. THE SHORT-TERM PROSPECT FOR THE DEFICIT IS NOT ENCOURAGING. THE OFFICIAL FORECAST FOR FY91 ON OLD DEFINITIONS IS DOLLARS 254 BILLION (DOLLARS 205 BILLION EXCLUDING THRIFTS AND SOCIAL SECURITY). THRIFT EXPENDITURE IS HIGHLY LIKELY TO EXCEED FORECAST. THE ECONOMY MIGHT ALSO CONTINUE TO PERFORM BELOW THE ADMINISTRATION'S FORECASTS. AND DEFENSE EXPENDITURE ON OPERATION DESERT SHIELD, WHICH IS EXCLUDED FROM THE BUDGET AGREEMENT, MAY WELL ADD FURTHER UPWARD PRESSURE TO THE DEFICIT.

8. FOR FY92 AND BEYOND, THE ADMINISTRATION'S ECONOMIC FORECAST LOOKS VERY OPTIMISTIC, WITH VERY STRONG GROWTH ACCOMPANIED BY SHARPLY DECLINING INTEREST RATES. IF INDEPENDENT FORECASTERS ARE MORE ACCURATE, THEN THE DEFICIT WILL BE HIGHER THAN CURRENTLY PREDICTED. MOREOVER THE UNEXPLAINED FACTORS WHICH HAVE INCREASED EXPENDITURE IN THE CURRENT FINANCIAL YEAR MAY CONTINUE TO PUSH THE DEFICIT UP. IT IS HIGHLY UNLIKELY, THEREFORE, THAT THE DEFICIT WILL REDUCE IN LINE WITH THE NEW DEFICIT TARGETS.

9. HOWEVER, EXPENDITURE ON THE THRIFT INDUSTRY REPRESENTS NO MORE THAN THE EXCHANGE OF ONE FORM OF FINANCIAL ASSET (TREASURY BONDS) FOR AN EXISTING FINANCIAL ASSET (A THRIFT DEPOSIT INSURED BY THE GOVERNMENT). IN THESE CIRCUMSTANCES BORROWING TO FINANCE THE THRIFT INDUSTRY BAIL OUT SHOULD NOT PUT EXTRA PRESSURE ON CREDIT MARKETS AND IT IS THEREFORE REASONABLE TO EXCLUDE IT FROM AN ASSESSMENT OF THE EFFECTS OF HIGHER DEFICITS. MOREOVER, SOME INCREASE IN THE DEFICIT CAN BE ACCEPTED AS A LOGICAL RESPONSE TO THE ECONOMIC DOWNTURN. AFTER ALLOWING FOR SUCH FACTORS, IT CURRENTLY LOOKS LIKELY THAT THE MEASURES AGREED IN THE BUDGET DEFICIT PACKAGE COULD LEAD TO SIGNIFICANT REDUCTIONS IN FUTURE DEFICITS. THE NEW ENFORCEMENT PROCEDURE SHOULD ENSURE THAT THE DEFENSE CUTS ARE ACHIEVED AND THAT NO OTHER POLICY CHANGES ERODE THE DEFICIT SAVINGS. THE CUTS IN MEDICARE AND THE INCREASES IN TAXES WILL RESULT IN DEFICIT SAVINGS YEAR BY YEAR WITHOUT FURTHER CONGRESSIONAL ACTION. TOTAL DEFICIT SAVINGS WILL AMOUNT TO 10 PER CENT OF THE TOTAL BUDGET BY 1995 - A NOT INSIGNIFICANT ADJUSTMENT. THE MEASURES ARE REAL : THAT IS WHY THE PACKAGE WAS SO DIFFICULT TO ENACT.

10. THE ADMINISTRATION AND THE FED HAVE CONTINUALLY ASSERTED THAT A SUBSTANTIAL AND CREDIBLE DEFICIT REDUCTION DEAL WILL LEAD

TO REDUCTIONS IN LONG-TERM INTEREST RATES. HOWEVER, WHILE IT MAY WELL BE LOGICALLY TRUE THAT INTEREST RATES WILL BE LOWER AS A RESULT OF THE PACKAGE THAN THEY WOULD OTHERWISE BE, IT IS NOT AT ALL OBVIOUS THAT THE DEFICIT AGREEMENT WILL LEAD TO A DOWNWARD TREND IN LONG-TERM INTEREST RATES FROM THEIR PRESENT LEVEL. FIRST, THE DEFICIT FORECAST IS NOW CONSIDERABLY HIGHER THAN IT WAS WHEN GREENSPAN FIRST PREDICTED A FALL IN LONG TERM RATES AND THE OUTTURN MAY BE HIGHER STILL. SECOND, THE REDUCTION IN NET SAVINGS IN GERMANY AND JAPAN MAY FORCE WORLD AND US INTEREST RATES UP. SIGNIFICANTLY, WHEN THE FED REDUCED THE SHORT-TERM FED FUNDS RATES ON 29 OCTOBER (IN RESPONSE TO THE ENACTMENT OF THE BUDGET DEAL), LONG-TERM RATES DID NOT FALL.

COMMENT

11. THE DEFICIT REDUCTION PACKAGE APPEARS TO REFLECT DEMOCRATIC PRIORITIES. WITH THE EXCEPTION OF THE MEDICARE CUTS, VIRTUALLY ALL THE POLICY CHANGES ARE THOSE TRADITIONALLY FAVOURED BY DEMOCRATS AND OPPOSED BY REPUBLICANS - NAMELY TAX INCREASES AND DEFENSE CUTS. ALTHOUGH THE PRESIDENT INDICATED HIS WILLINGNESS TO ACCEPT DEFENSE CUTS (AND SOME CUTS WERE INCLUDED IN HIS JANUARY BUDGET) THE CUTS EVENTUALLY AGREED WERE SUBSTANTIALLY IN EXCESS OF HIS OPENING BID. DOMESTIC DISCRETIONARY EXPENDITURE WAS ACTUALLY INCREASED. MEDICARE CUTS WERE MODEST AND THE REMAINING POLICY CHANGES WERE TAX INCREASES.

12. ON THE OTHER HAND, THE BUDGET ENFORCEMENT MEASURES APPEAR TO SHIFT POWER TO THE PRESIDENT. THE QUOTE PAY AS YOU GO UNQUOTE RULE AND THE LIMITS ON APPROPRIATIONS WITH AUTOMATIC SEQUESTERS TO ENFORCE THEM, PREVENT CONGRESS FROM ADOPTING ANY NEW SPENDING INITIATIVE WITHOUT ALSO ADOPTING OFFSETTING SPENDING CUTS OR FROM ADOPTING TAX BREAKS WITHOUT TAX INCREASES. THIS POLICY CONSTRAINT CAN ONLY BE OVERRIDDEN WITH THE AGREEMENT OF THE PRESIDENT OR ON A TWO-THIRDS VOTE IN CONGRESS. IN PRACTICE, THIS GIVES THE PRESIDENT A VETO OVER NEW SPENDING OR TAX INITIATIVES - A SEVERE POLICY STRAIGHTJACKET WHICH WAS NOT EXTENSIVELY DISCUSSED WITHIN THE CONGRESS AS PART OF THE BUDGET DEAL, AND MAY WELL CAUSE FRICTION IN THE FUTURE.

13. IT IS POSSIBLE THAT THE FAILURE OF THE MARKETS TO REACT POSITIVELY, THE POSSIBLE CONTINUING DIFFICULTY OF FUNDING THE BUDGET DEFICITS WITHOUT AN INTEREST RATE INCREASE, AND THE CONSTRAINTS ON POLICY INITIATIVES FORCED BY THE BUDGET ENFORCEMENT MECHANISM, WILL PROMPT CONGRESS TO ENACT A FURTHER, TOUGHER, BUDGET DEAL IN THE NEXT YEAR OR SO. BUT, THE EXPERIENCE THIS YEAR HAS NOT BEEN A HAPPY ONE FOR CONGRESSMEN AND IT WOULD PROBABLY REQUIRE A SERIOUS CRISIS TO FORCE FURTHER EARLY ACTION. ON BALANCE, CONGRESS IS LIKELY TO WANT TO ACCEPT DEFICITS OF DOLLARS 200-250 BILLION OVER THE NEXT TWO

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YEARS, SHRUGGING OFF OVERRUNS AND TRUSTING IN THE MEASURES ALREADY
TAKEN TO BRING THE DEFICIT DOWN IN DUE COURSE. THE NEW BUDGET
ENFORCEMENT PROCEDURE ALLOWS THEM TO DO THIS. IT MAY INDEED BE
THE MOST APPROPRIATE POLICY.

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TELNO 2508

OF 171919Z OCTOBER 90

AND TO IMMEDIATE TREASURY, BANK OF ENGLAND, DTI, INLAND REVENUE
INFO IMMEDIATE OTTAWA, BONN, PARIS, ROME, TOKYO, ACTOR

TREASURY FOR PS/CHANCELLOR, WICKS, ALLAN, MRS LOMAX, CULPIN
BANK FOR GREEN
DTI FOR HAGESTADT
INLAND REVENUE FOR HOUGHTON, FAWCETT, CAYLEY *mt*

MY TELNO 2473 : US BUDGET DEFICIT

SUMMARY

HOUSE OF REPRESENTATIVES PASSES A PARTISAN DEMOCRATIC BUDGET WITH
INCOME TAX INCREASES. BUSH THREATENS VETO. SENATE DEBATES MORE
MODERATE BUDGET, PROBABLY ACCEPTABLE TO BUSH. TIME FOR
COMPROMISE RUNNING OUT. SECOND GOVERNMENT SHUT DOWN OVER THE
WEEKEND OF 20-21 OCTOBER LIKELY. NEVERTHELESS, PROSPECTS FOR AN
EVENTUAL BUDGET DEAL NOW BETTER.

DETAIL

2. FOLLOWING THE HOUSE OF REPRESENTATIVES' REJECTION OF THE
BUDGET AGREEMENT, CONGRESS PASSED A NEW, LESS SPECIFIC, BUDGET
RESOLUTION ON 8 OCTOBER. THIS MAINTAINED THE SAME BUDGET DEFICIT
REDUCTION TARGETS (DOLLARS 40 BILLION IN FY91 AND DOLLARS 500
BILLION OVER 5 YEARS), BUT GAVE MORE FLEXIBILITY TO CONGRESSIONAL
COMMITTEES IN DETERMINING THE COMPONENTS OF THE PACKAGE. AS
CONGRESSIONAL COMMITTEES WORKED ON THE DETAILS, IT BECAME CLEAR
THAT, DESPITE THE EMOTION OF THE BUDGET RESOLUTION DEBATES, THE
AREAS OF DISAGREEMENT WITH THE ORIGINAL BUDGET DEAL WERE FAIRLY
NARROW.

3. THE REPUBLICANS IN THE HOUSE OPPOSED THE TAX INCREASES AND
WERE DISAPPOINTED BY THE ABSENCE OF A CAPITAL GAINS TAX (CGT)
CUT. THE HOUSE DEMOCRATS WERE OPPOSED TO THE SCALE OF THE
MEDICARE CUTS (DOLLARS 60 BILLION OVER 5 YEARS), TO THE GROWTH
INCENTIVES (TAX BREAKS), AND TO THE OVERALL REGRESSIVITY OF A
PACKAGE WHICH PUT UP EXCISE TAXES ON MIDDLE INCOME GROUPS BUT
FAILED TO INCREASE TAXES SUBSTANTIALLY ON THE RICH. IN THE
SENATE BOTH DEMOCRATS AND REPUBLICANS SHARED THE GENERAL VIEWS OF
THEIR HOUSE COLLEAGUES, BUT IT BECAME CLEAR THAT THEY WOULD HAVE
ACCEPTED SOMETHING LIKE THE ORIGINAL AGREEMENT.

PAGE 1
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4. THE STRATEGY ADOPTED BY THE DEMOCRATIC LEADERSHIP (IN WHICH BUSH ACQUIESCED, ACCORDING TO OMB CONTACTS) WAS TO WRITE OFF THE HARD LINE HOUSE REPUBLICANS AND MAKE THE MINIMUM POSSIBLE CHANGES TO THE BUDGET - SHIFTING THE BALANCE JUST ENOUGH TO SECURE THE SUPPORT OF DEMOCRATS WHILE RETAINING THAT OF THE SENATE REPUBLICANS. IN PRACTICE, THIS MEANT REDUCING THE MEDICARE CUTS BY ABOUT DOLLARS 10 BILLION, DROPPING THE TAX BREAKS FOR THE RICH AND INTRODUCING A FEW OTHER CHANGES TO THE REVENUE PACKAGE SO AS TO SHIFT THE BURDEN TO UPPER INCOME EARNERS. OTHER ELEMENTS WERE TO BE LEFT BASICALLY UNCHANGED.
5. THIS STRATEGY HAS BEEN LARGELY SUCCESSFUL. THE REDUCTION IN MEDICARE CUTS, AND THE REMOVAL OF THE REVENUE-LOSING TAX BREAKS, HAS BEEN ACCEPTED BY MOST PLAYERS. THE DEBATE THEREFORE HAS CONCENTRATED ON HOW THE OVERALL BALANCE OF THE TAX PACKAGE COULD BE CHANGED.
6. ON THIS POINT BUSH HAS STUMBLER BY GIVING CONFLICTING SIGNALS (AS REPORTED IN MY TUR). WHATEVER BUSH ACTUALLY SAID, THE PERCEPTION NOW IS THAT HE DID AT FIRST INDICATE THAT HE COULD ACCEPT AN INCREASE IN INCOME TAX RATES IN RETURN FOR A CAPITAL GAINS TAX CUT, BUT THEN REVERSED HIS POSITION WHEN A STORM OF PROTEST SHOWED THAT HE WOULD LOSE EVEN THE MORE MODERATE SENATE REPUBLICANS BY OFFERING SUCH A DEAL. IN RESPONSE TO CRITICISM OF HIS INDECISION, HE MADE MATTERS WORSE BY ARGUING THAT HE WOULD HAVE ACCEPTED A DEAL BUT NOT ON TERMS TO WHICH THE DEMOCRATS WERE LIKELY TO HAVE AGREED.
7. THIS PREVARICATION SET BACK EFFORTS TO BUILD A CONSENSUS AROUND A FEW MINIMAL CHANGES TO THE ORIGINAL BUDGET AGREEMENT. THE SENATE LEADERSHIP HAD GENUINELY BEEN LOOKING FOR A BIPARTISAN APPROACH. SENATOR BENTSEN (CHAIRMAN OF THE SENATE FINANCE COMMITTEE) WAS PUT OUT BY BEING ENCOURAGED TO FOLLOW THE PRESIDENT UP ONE COMPROMISE PATH, ONLY TO FIND BUSH APPARENTLY REVERSING POSITION. THE DEMOCRAT MAJORITY IN THE SENATE IS, HOWEVER, NOT ENOUGH TO ALLOW ANYTHING OTHER THAN A BIPARTISAN APPROACH, SO BENTSEN GRITTED HIS TEETH AND BATTLED ON EVENTUALLY GETTING A NEW TAX PACKAGE THROUGH THE SENATE FINANCE COMMITTEE. IN THE HOUSE, THE DEMOCRATS, HAVING ALREADY PASSED ONE BIPARTISAN PACKAGE THROUGH THE WAYS AND MEANS COMMITTEE (KNOWN AS THE QUOTE BARE BONES UNQUOTE PACKAGE), THEN DECIDED TO PROPOSE A FULL BLOODED DEMOCRATIC ALTERNATIVE BUDGET WHICH SHIFTED THE TAX BURDEN SHARPLY TO THE RICH.
8. AS THE FULL HOUSE DEBATED THE BUDGET ON 16 OCTOBER THEY THUS HAD TWO ALTERNATIVE PACKAGES BEFORE THEM :
- (A) THE BARE BONES PACKAGE, WHICH DROPPED ALL TAX BREAKS AGREED IN THE BUDGET SUMMIT, REDUCED MEDICARE CUTS BY

DOLLARS 10 BILLION OVER 5 YEARS, BUT OTHERWISE KEPT TO THE ESSENTIALS OF THE BUDGET AGREEMENT : AND
(B) THE DEMOCRATIC ALTERNATIVE, WHICH, IN ADDITION TO THE MEASURES AT (A) ABOVE, INCREASED INCOME TAX RATES, RAISED THE ALTERNATIVE MINIMUM TAX, SUSPENDED THE INDEXATION OF TAX BREAKS FOR ONE YEAR, IMPOSED A 10 PER CENT SURTAX ON INCOME ABOVE DOLLARS 1 MILLION, REMOVED THE INCREASE IN GAS TAXES, AND INTRODUCED A NEW CAPITAL GAINS TAX CUT, DESIGNED TO HELP MIDDLE INCOME EARNERS RATHER THAN THE RICH.

THE HOUSE REPUBLICANS TRIED TO INTRODUCE A PACKAGE OF THEIR OWN, BUT COULD NOT AGREE ON ONE WHICH MET THE OVERALL DEFICIT REDUCTION TARGET.

9. IN THE EVENT, THE HOUSE ADOPTED (B) ABOVE BY 227 TO 203 ON AN ESSENTIALLY PARTY LINE VOTE. BUSH IMMEDIATELY ANNOUNCED THAT HE WOULD VETO THE PACKAGE.

10. ON 17 OCTOBER THE SENATE BEGAN TO DEBATE AN ALTERNATIVE DRAWN UP BY SENATOR BENTSEN AND PASSED BY THE FINANCE COMMITTEE. THIS REDUCES THE MEDICARE CUTS AND DROPS SOME (BUT NOT ALL) OF THE TAX BREAKS IN THE ORIGINAL BUDGET AGREEMENT. IT ALTERS THE DISTRIBUTIONAL BALANCE OF THE PACKAGE BY ENHANCING EARNED INCOME TAX CREDITS FOR THE LOW INCOME EARNERS, PAID FOR BY A MORE SEVERE LIMITATION ON THE AMOUNT OF TAX DEDUCTIONS HIGHER INCOME EARNERS COULD CLAIM. FURTHER AMENDMENTS, INCLUDING AN INCOME TAX INCREASE, IN EXCHANGE FOR A CAPITAL GAINS TAX CUT ARE LIKELY TO BE OFFERED BUT THE LEADERSHIP WILL TRY TO HOLD TO THE BENTSEN PACKAGE.

11. THE SENATE HAS SET ASIDE AT LEAST 20 HOURS FOR DEBATE ON ITS BUDGET. THERE WILL THEN HAVE TO BE A HOUSE/SENATE CONFERENCE TO RECONCILE DIFFERENCES BETWEEN THE PACKAGES PASSED BY BOTH CHAMBERS, AND, FINALLY, A FURTHER FLOOR VOTE IN BOTH CHAMBERS. TO ACHIEVE ALL THAT BY MIDNIGHT ON 19 OCTOBER (WHEN TEMPORARY FUNDING FOR THE GOVERNMENT EXPIRES) LOOKS ALMOST IMPOSSIBLE. THE PRESIDENT HAS SAID THAT HE WILL VETO A FURTHER TEMPORARY FUNDING BILL UNLESS A BUDGET AGREEMENT IS IMMINENT. THERE COULD THEREFORE WELL BE A FURTHER SHUT DOWN OF GOVERNMENT OVER THE WEEKEND OF 20-21 OCTOBER.

COMMENT

12. DESPITE THE HARSH WORDS BETWEEN DEMOCRATS AND BUSH, THE SHARP DIFFERENCES OVER INCOME TAX INCREASES AND THE POSSIBILITY OF A GOVERNMENT SHUT DOWN OVER THE WEEKEND, THE PROSPECTS FOR A SUCCESSFUL BUDGET DEAL DO NOT LOOK NOW TOO BAD. THE HOUSE DEMOCRATS KNOW THAT NEITHER THE SENATE NOR BUSH WILL ACCEPT THEIR PACKAGE WITH ITS INCOME TAX RATE INCREASES. IT SEEMS PROBABLE THAT, HAVING MADE THEIR STAND, THEY WILL COMPROMISE ON SOMETHING LIKE THE BUDGET PACKAGE PASSED BY THE SENATE FINANCE AND BUDGET

4. THE STRATEGY ADOPTED BY THE DEMOCRATIC LEADERSHIP (IN WHICH BUSH ACQUIESCED, ACCORDING TO OMB CONTACTS) WAS TO WRITE OFF THE HARD LINE HOUSE REPUBLICANS AND MAKE THE MINIMUM POSSIBLE CHANGES TO THE BUDGET - SHIFTING THE BALANCE JUST ENOUGH TO SECURE THE SUPPORT OF DEMOCRATS WHILE RETAINING THAT OF THE SENATE REPUBLICANS. IN PRACTICE, THIS MEANT REDUCING THE MEDICARE CUTS BY ABOUT DOLLARS 10 BILLION, DROPPING THE TAX BREAKS FOR THE RICH AND INTRODUCING A FEW OTHER CHANGES TO THE REVENUE PACKAGE SO AS TO SHIFT THE BURDEN TO UPPER INCOME EARNERS. OTHER ELEMENTS WERE TO BE LEFT BASICALLY UNCHANGED.

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9. IN THE EVENT, THE HOUSE ADOPTED (B) ABOVE BY 227 TO 203 ON AN ESSENTIALLY PARTY LINE VOTE. BUSH IMMEDIATELY ANNOUNCED THAT HE WOULD VETO THE PACKAGE.

10. ON 17 OCTOBER THE SENATE BEGAN TO DEBATE AN ALTERNATIVE DRAWN UP BY SENATOR BENTSEN AND PASSED BY THE FINANCE COMMITTEE. THIS REDUCES THE MEDICARE CUTS AND DROPS SOME (BUT NOT ALL) OF THE TAX BREAKS IN THE ORIGINAL BUDGET AGREEMENT. IT ALTERS THE DISTRIBUTIONAL BALANCE OF THE PACKAGE BY ENHANCING EARNED INCOME TAX CREDITS FOR THE LOW INCOME EARNERS, PAID FOR BY A MORE SEVERE LIMITATION ON THE AMOUNT OF TAX DEDUCTIONS HIGHER INCOME EARNERS COULD CLAIM. FURTHER AMENDMENTS, INCLUDING AND INCOME TAX INCREASE, IN EXCHANGE FOR A CAPITAL GAINS TAX CUT ARE LIKELY TO BE OFFERED BUT THE LEADERSHIP WILL TRY TO HOLD TO THE BENTSEN PACKAGE.

11. THE SENATE HAS SET ASIDE AT LEAST 20 HOURS FOR DEBATE ON ITS BUDGET. THERE WILL THEN HAVE TO BE A HOUSE/SENATE CONFERENCE TO RECONCILE DIFFERENCES BETWEEN THE PACKAGES PASSED BY BOTH CHAMBERS, AND, FINALLY, A FURTHER FLOOR VOTE IN BOTH CHAMBERS. TO ACHIEVE ALL THAT BY MIDNIGHT ON 19 OCTOBER (WHEN TEMPORARY FUNDING FOR THE GOVERNMENT EXPIRES) LOOKS ALMOST IMPOSSIBLE. THE PRESIDENT HAS SAID THAT HE WILL VETO A FURTHER TEMPORARY FUNDING BILL UNLESS A BUDGET AGREEMENT IS IMMINENT. THERE COULD THEREFORE WELL BE A FURTHER SHUT DOWN OF GOVERNMENT OVER THE WEEKEND OF 20-21 OCTOBER.

COMMENT

12. DESPITE THE HARSH WORDS BETWEEN DEMOCRATS AND BUSH, THE SHARP DIFFERENCES OVER INCOME TAX INCREASES AND THE POSSIBILITY OF A GOVERNMENT SHUT DOWN OVER THE WEEKEND, THE PROSPECTS FOR A SUCCESSFUL BUDGET DEAL DO NOT LOOK NOW TOO BAD. THE HOUSE DEMOCRATS KNOW THAT NEITHER THE SENATE NOR BUSH WILL ACCEPT THEIR PACKAGE WITH ITS INCOME TAX RATE INCREASES. IT SEEMS PROBABLE THAT, HAVING MADE THEIR STAND, THEY WILL COMPROMISE ON SOMETHING LIKE THE BUDGET PACKAGE PASSED BY THE SENATE FINANCE AND BUDGET

COMMITTEES AND CURRENTLY BEING DEBATED IN THE SENATE. THAT PACKAGE IS MORE PROGRESSIVE THAN THE ORIGINAL AGREEMENT, WITHOUT AFFECTING INCOME TAX RATES. IT ALSO REMAINS A CREDIBLE DEFICIT CUTTING PACKAGE WHICH PROVIDES SOME HOPE OF REDUCING THE ANNUAL DEFICITS OVER THE NEXT 5 YEARS.

ACLAND

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DISTRIBUTION

478

MAIN

478

FCO/WHITEHALL

NAD

NNNN

RESTRICTED
FM WASHINGTON
TO IMMEDIATE FCO
TELNO 2473
OF 122040Z OCTOBER 90
AND TO IMMEDIATE TREASURY, BANK, DTI, INLAND REVENUE
INFO IMMEDIATE OTTAWA, BONN, PARIS, ROME, TOKYO, ACTOR

TREASURY FOR PS/CHANCELLOR, WICKS, ALLAN, MRS LOMAX, CULPIN
BANK FOR GREEN
DTI FOR HAGESTADT
INLAND REVENUE FOR HOUGHTON, FAWCETT, CAYLEY

MY TELNO 2452 (NOT TO ALL): US BUDGET DEFICIT

SUMMARY

1. CONFUSION, ESPECIALLY OVER THE PRESIDENT'S VIEWS, REIGNS. BUT, AMID THE CONFUSION, SIGNS THAT THE ELEMENTS OF A REVISED BUDGET DEAL MAY BE EMERGING.
2. A POSSIBLE TRADE-OFF BETWEEN INCOME TAX INCREASES AND CAPITAL GAINS TAX CUTS REMAINS THE STICKING POINT, AND THE CAUSE OF MOST OF THE CONFUSION. TOO EARLY TO ASSESS HOW MUCH THIS WEEK'S EVENTS HAVE DAMAGED THE PRESIDENT AND BOTH PARTIES' POLITICAL FORTUNES.

DETAIL

3. AS THE BRITISH AND AMERICAN PRESS HAVE REPORTED WITH RELISH, THE BUDGET NEGOTIATIONS HAVE BECOME EVEN MORE CONFUSED IN THE 3 DAYS SINCE MY TUR, OWING MAINLY TO EXTRAORDINARY EQUIVOCATION ON THE PART OF THE PRESIDENT.
4. ALTHOUGH THE CONGRESSIONAL COMMITTEES ARE CERTAIN TO MISS THE DEADLINE OF 12 OCTOBER FOR FINISHING WORK ON THE REVISED BUDGET PROPOSALS, THERE HAVE BEEN SIGNS AMID THE CONFUSION THAT THE TWO MAIN TAX-WRITING COMMITTEES - THE SENATE FINANCE COMMITTEE (CHAIRIED BY BENTSEN) AND THE HOUSE WAYS AND MEANS COMMITTEE (ROSTENKOWSKI) - ARE CLOSE TO PRODUCING NEGOTIABLE PACKAGES WHICH, IN SENATOR DOLE'S WORDS, QUOTE SMOOTH THE EDGES OFF UNQUOTE THE AGREEMENT DEFEATED ON 5 OCTOBER. MOST MEMBERS SEEM NOW TO AGREE THAT THE REVISED PACKAGE WOULD INCLUDE SMALLER INCREASES IN GASOLINE AND SIN TAXES, AND MEDICARE PREMIUMS, AND PROBABLY CUT MORE FROM DEFENCE, THAN ITS PREDECESSOR.

5. AS ALWAYS, HOWEVER, THE STICKING POINT IS INCOME TAX, IN PARTICULAR WHETHER AN INCREASE IN THE TOP RATE SHOULD BE ACCEPTED BY THE REPUBLICANS IN EXCHANGE FOR A CUT IN CAPITAL GAINS TAX. THE PRESIDENT'S SHIFTING ATTITUDE TO SUCH A DEAL, STRONGLY FAVOURED BY THE REPUBLICANS ON THE HOUSE WAYS AND MEANS COMMITTEE, HAS BEEN THE CAUSE OF MOST OF THE CONFUSION OF THE PAST FEW DAYS. IN ESSENCE, THE PRESIDENT'S VIEW IS LESS INCONSISTENT THAN HE HAS LET IT SEEM: HE WOULD NOT BE OPPOSED TO A DEAL WHICH RAISED THE TOP INCOME TAX RATE TO 31 PER CENT IN EXCHANGE FOR A CUT IN CAPITAL GAINS FROM 28 TO 15 PER CENT, BUT HE ALSO BELIEVES THAT SUCH A DEAL IS LIKELY TO BE BLOCKED BY THE DEMOCRATS, AND SHOULD NOT (NOT) THEREFORE BE PURSUED.

6. UNTIL THE INCOME/CAPITAL GAINS TAX ISSUE IS RESOLVED - PROBABLY BY AGREEING NOT TO CHANGE EITHER, - THERE WILL BE NO BUDGET DEAL: AND THE QUOTE FINAL UNQUOTE DEADLINE OF 19 OCTOBER, AND THE ELECTIONS ON 6 NOVEMBER, ARE NOW PERILOUSLY CLOSE. THESE SHOULD HELP TO CONCENTRATE MINDS: BUT THERE MUST BE A REAL CHANCE THAT A SUBSTANTIVE DEAL WILL NOT BE REACHED BEFORE CONGRESS RECESSES FOR THE ELECTIONS.

7. IT IS TOO EARLY TO MAKE A REALISTIC ASSESSMENT OF HOW MUCH LONGER TERM DAMAGE MAY HAVE BEEN DONE TO THE PRESIDENT OR EITHER OR EVEN BOTH OF THE TWO PARTIES. THE PRESENT OUTBURST OF CRITICAL COMMENT IN THE NATIONAL MEDIA ABOUT PRESIDENTIAL QUOTE FLIP-FLOPS UNQUOTE AND SUGGESTIONS THAT THE BUSH ADMINISTRATION MAY NOW BE AT RISK OF QUOTE CARTERISATION UNQUOTE, WILL NOT NECESSARILY MAKE A LASTING IMPACT ON THE COUNTRY AS A WHOLE. THE IMMEDIATE REACTION TO THE PRESIDENT'S HANDLING OF THE BUDGET ISSUE, HOWEVER, HAS BEEN SHOWN BY A SHARP DROP OF ABOUT 20 POINTS IN HIS OVERALL APPROVAL RATING FROM OVER 70 PER CENT. THAT COULD CHANGE RAPIDLY, AND THE CRITICISM IS BY NO MEANS ALL OF THE PRESIDENT: POPULAR DISILLUSIONMENT WITH THE WAY WASHINGTON WORKS AND WITH THE CONGRESS HAS PROBABLY BEEN DEEPEENED FURTHER. CONFIDENCE IN THE PRESIDENTS'S ABILITY TO DEAL WITH DOMESTIC PROBLEMS WOULD BE STRENGTHENED IF A REASONABLY SATISFACTORY BUDGET DEAL WERE REACHED FAIRLY SOON, PARTICULARLY IF HE IS ABLE IN THE MEANTIME TO EXERCISE FIRMER LEADERSHIP THAN HE HAS THIS WEEK. BUSH HAS ALWAYS, OF COURSE, HAD HIGHER RATINGS FOR HIS HANDLING OF FOREIGN THAN DOMESTIC ISSUES. BUT HE WILL NOT HAVE HELPED HIMSELF BY HIS CANDID ADMISSION ON 9 OCTOBER THAT HE WAS MORE COMFORTABLE WITH DIPLOMACY.

RESTRICTED
FM WASHINGTON
TO IMMEDIATE FCO
TELNO 2477
OF 122206Z OCTOBER 90
AND TO IMMEDIATE TREASURY, BANK.

FCO PLEASE ADVANCE TO PS/CHANCELLOR, ALLAN, GRAY, TREASURY
AND TO GREEN, BANK.

US MONETARY POLICY

SUMMARY

1. DESPITE WEAKER DOLLAR AND RISING INFLATION FED
REPORTEDLY READY TO EASE INTEREST RATES IN RESPONSE TO
BUDGET PACKAGE, IF ACHIEVED. ANALYSTS WIDELY EXPECT SHORT
RATES TO BE HALF PERCENT LOWER BY YEAR END.

DETAIL

2. THE FOMC, THE FED'S MONETARY POLICY COMMITTEE, MET ON
2 OCTOBER (AFTER ANNOUNCEMENT OF THE BUDGET AGREEMENT BETWEEN
THE WHITE HOUSE AND CONGRESSIONAL LEADERSHIP BUT PRIOR TO
ITS REJECTION BY THE HOUSE OF REPRESENTATIVES). DESPITE A
TRADITION OF SECRECY, THIS WEEK'S PRESS HAS INCLUDED TWO
RELATIVELY DETAILED REPORTS (WHICH FED CONTACTS SUGGEST ARE
ACCURATE) OF THE FED'S DELIBERATIONS.

3. ACCORDING TO THESE REPORTS, THE FED AGREED ON 2 OCTOBER
TO STAND READY TO MAKE A SMALL DOWNWARD ADJUSTMENT TO THE
FEDERAL FUNDS RATE - PROBABLY OF AROUND ONE QUARTER OF ONE
PERCENT - IN THE EVENT OF A BUDGET AGREEMENT. THIS PLAN
HAS BEEN SCUPPERED, AT LEAST TEMPORARILY, BY THE DEFEAT OF
THE FIRST BUDGET PACKAGE. GREENSPAN IS ALSO REPORTED TO
HAVE PROPOSED A SECOND EASING IN VIEW OF THE DETERIORATING
ECONOMIC OUTLOOK. BUT AS SOME MEMBERS OF THE COMMITTEE
REMAINED CONCERNED ABOUT INFLATIONARY
PRESSURES AND, TO A LESSER EXTENT, THE WEAKNESS OF THE
DOLLAR THIS OPTION WAS, FOR THE MOMENT, REJECTED.

4. THIS CAUTION IS PARTLY A LEGACY OF THE POLICY EASING
ADOPTED IN JULY. DESPITE GREENSPAN'S EXPLANATION THAT

CREDIT CONDITIONS THEN WARRANTED SUCH A MOVE, MARKETS SUSPECTED THAT THE FED'S ANTI-INFLATION RESOLVE HAD WEAKENED AND LONG BOND YIELDS WERE MARKED UP, THEREBY OFFSETTING PART OF THE DESIRED EASING.

5. IN THE LIGHT OF THE LATEST PRESS REPORTS, CONGRESSIONAL SUCCESS IN PASSING A RECONCILIATION BILL FOR THE FY91 BUDGET IS LIKELY TO RESULT IN FAIRLY DIRECT FED EASING. PROSPECTS FOR A FURTHER EASING ARE LESS CLEAR. MOST ECONOMISTS EXPECT THAT THE GROWING RISK OF A RECESSION - ACKNOWLEDGED PUBLICLY BY THE TREASURY FOR THE FIRST TIME THIS WEEK-WILL LEAD TO A FULL HALF POINT REDUCTION IN SHORT RATES BY THE END OF THE YEAR. BUT IT MAY TAKE TIME FOR A CLEAR MAJORITY TO DEVELOP IN THE FED IN FAVOUR OF THIS.

COMMENT

7. IT IS HIGHLY UNUSUAL FOR THE FED'S MONETARY POLICY DELIBERATIONS TO LEAK TO THE PRESS IN SUCH DETAIL. THE REPORTS PROBABLY ORIGINATE FROM A COMMITTEE SUPPORTER OF GREENSPAN'S REJECTED CALL FOR EASING. THAT THIS MEMBER WAS WILLING TO AIR THE DEBATE IN PUBLIC SUGGESTS BOTH CONCERN ABOUT THE NEED FOR EASING AND THE EXISTENCE OF STRONG DISAGREEMENT WITHIN THE FED AS TO WHETHER THIS IS THE RIGHT COURSE. THUS, THE DEBATE ABOUT THE RELATIVE WEIGHT TO ACCORD TO GROWTH OR INFLATION - FORMERLY MOST MARKED BETWEEN THE FED AND THE WHITE HOUSE - HAS NOW SPREAD TO THE FED. MOST ANALYSTS EXPECT THE ARGUMENT TO RESOLVE IN FAVOUR OF EASIER POLICY AS THE SIGNS OF A WEAKER ECONOMY CUMULATE.

8. IT APPEARS UNLIKELY THAT THE LEAKED REPORTS WERE DESIGNED TO HAVE A DIRECT EFFECT ON CURRENT BUDGET NEGOTIATIONS. HOWEVER, BY PUTTING ON RECORD THE FOMC DECISION TO EASE IN RESPONSE TO A BUDGET PACKAGE IT WILL BE DIFFICULT FOR THE FED NOT TO DO SO, EVEN IF THE FINAL PACKAGE IS LESS AMBITIOUS THAN THAT INITIALLY PROPOSED.

ACLAND

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ADVANCE COPY

RESTRICTED

FM WASHINGTON

TO DESKBY 100900Z FCO

TELNO 2452

OF 100350Z OCTOBER 90

AND TO IMMEDIATE TREASURY, BANK, INLAND REVENUE, ACTOR

RESIDENT CLERK PLEASE PASS DESKBY 100900Z TO NO 10
FCO PLEASE ADVANCE TO NO 10, PS/CHANCELLOR, ALLAN, MRS LOMAX
MRS M BROWN, TREASURY, GREEN, BANK AND FAWCETT, INLAND REVENUE

MY TELNO 2428: US BUDGET DEFICIT *mt*

SUMMARY

1. FOLLOWING DEFEAT OF BUDGET DEFICIT AGREEMENT, CONGRESS SPENT HOLIDAY WEEKEND PREPARING NEW OUTLINE BUDGET RESOLUTION. NEW PLAN SIMILAR TO, BUT MUCH LESS SPECIFIC THAN, EARLIER VERSION AND MODIFIED TO MEET CONGRESSIONAL OBJECTIONS TO EARLIER PLANS. LIKELY TO BITE LESS DEEPLY ESPECIALLY ON MEDICARE. NOW UP TO RELEVANT CONGRESSIONAL COMMITTEES TO FILL IN THE DETAILS. NEW DEADLINE 19 OCTOBER. PROGNOSIS VERY UNCERTAIN. AMERICAN PUBLIC EVIDENTLY BLAME PRESIDENT BUSH AND THE CONGRESS ABOUT EQUALLY FOR THE CONFUSION SO FAR.

DETAIL

2. THE DEFEAT ON 5 OCTOBER OF THE BUDGET DEFICIT AGREEMENT LABORIOUSLY WORKED OUT BETWEEN THE ADMINISTRATION AND THE CONGRESSIONAL LEADERSHIP WAS FOLLOWED BY A CONFUSED COLUMBUS DAY HOLIDAY WEEKEND. PRESIDENT BUSH VETOED ON 6 OCTOBER A CONTINUING RESOLUTION PASSED BY BOTH HOUSE AND SENATE WHICH WOULD HAVE KEPT THE GOVERNMENT IN FUNDS (BUT TEMPORARILY STAVED OFF A SEQUESTER). TECHNICALLY, THE ADMINISTRATION WERE THEREFORE INSOLVENT. IN PRACTICE, THE ONLY TANGIBLE EFFECT WAS THE CLOSURE OF SOME NATIONAL PARKS AND MONUMENTS.

3. CONFRONTED WITH THE PROSPECT OF A COMPLETE GOVERNMENT SHUT DOWN ON 9 OCTOBER, DEMOCRATS IN THE HOUSE OF REPRESENTATIVES

SPENT THE WEEKEND DEVISING A NEW BUDGET DEFICIT RESOLUTION. THIS WAS APPROVED BY THE HOUSE OF REPRESENTATIVES BY 250-164, AND, SUBSEQUENTLY, WITH SOME MODIFICATION, BY THE SENATE, BY VOICE VOTE. CONGRESS ALSO PASSED A REPETITION OF THE EARLIER (DEFEATED) CONTINUING RESOLUTION KEEPING THE GOVERNMENT IN FUNDS UNTIL 19 OCTOBER. THESE MEASURES WERE APPROVED BY THE PRESIDENT ON 9 OCTOBER. CONGRESS HAS ALSO EXTENDED THE GOVERNMENT'S DEBT CEILING LIMIT UNTIL 19 OCTOBER, WITHOUT WHICH THE GOVERNMENT WOULD HAVE GONE INTO DEFAULT ON 11 OCTOBER.

4. THE NEW BUDGET DEFICIT PLAN IS ONLY AN OUTLINE. IT PROVIDES FOR THE SAME OVERALL FIGURES AS IN THE EARLIER VERSION (A REDUCTION OF DLRS 40 BN IN THE DEFICIT IN FY 1991, AND OF DLRS 500 BN OVER THE NEXT 5 YEARS). THE DEFENCE FIGURES ARE SUBSTANTIALLY UNCHANGED. BUT MANY OF THE DETAILED FIGURES AND SPECIFIC UNDERSTANDINGS REACHED EARLIER BETWEEN THE ADMINISTRATION AND

CONGRESS HAVE BEEN NULLIFIED. IT WILL NOW BE UP TO THE TAX WRITING AND SPENDING COMMITTEES OF CONGRESS TO FLESH OUT THE AGREEMENT AS BEST THEY CAN.

5. BUT THE MAIN CHANGES ARE THAT MEDICARE WOULD NOW BE CUT BY ABOUT DLRS 40 BN RATHER THAN DLRS 60 BN. ANY SPECIFIC NEW TAXES ON GASOLINE, CIGARETTES AND ALCOHOL WILL HAVE TO BE DETERMINED BY CONGRESS. THE EARLIER PROPOSED NEW TAX BREAKS FOR BUSINESS MAY DISAPPEAR. THE HIGHLY CONTROVERSIAL PROPOSED 2 CENTS A GALLON ON HOME HEATING OIL, AND THE PROPOSED DENIAL OF UNEMPLOYMENT BENEFITS DURING THE FIRST 2 WEEKS IN WHICH A PERSON WAS UNEMPLOYED, WILL PROBABLY BE REMOVED. THE NEW AGREEMENT LEAVES OPEN THE POSSIBILITY OF AN INCREASE IN THE TOP TAX RATE AND/OR A CUT IN CAPITAL GAINS TAX.

6. THE LAST FOUR DAYS HAVE BEEN FULL OF UNCERTAINTY AND RECRIMINATION IN WASHINGTON. THE DUST IS STILL SETTLING. BUT SOME THINGS ARE CLEAR. RELATIONS BETWEEN CONGRESS AND WHITE HOUSE HAVE SUFFERED (DARMAN AND SUNUNU ARE SAID TO BE IN PARTICULARLY BAD ODOUR FOR TRYING TO BULLY BOTH DEMOCRATS AND REPUBLICANS INTO SUPPORTING THE EARLIER PLAN). THE DEMOCRATIC AND REPUBLICAN LEADERSHIP OF BOTH HOUSES HAVE BEEN SEEN TO BE OUT OF STEP WITH THEIR RANK AND FILE. SPEAKER FOLEY'S AUTHORITY PARTICULARLY HAS SUFFERED FOR HAVING NEGOTIATED, AND COMMENDED TO HIS SUPPORTERS,

A PLAN WHICH WAS SEEN BY MANY DEMOCRATS AS A BETRAYAL OF DEMOCRATIC PRINCIPLES. BUT THE REPUBLICANS, PARTICULARLY IN THE HOUSE OF REPRESENTATIVES, ARE SEVERELY SPLIT BETWEEN MODERATE AND RADICAL WINGS, THE LATTER LED BY THE INCENDIARY MINORITY WHIP, NEWT GINGRICH, WHOSE DISLOYALTY HAS ANGERED THE WHITE HOUSE. THE REPUBLICANS WERE SO DEEPLY DIVIDED THAT THEY WERE INCAPABLE OF PLAYING ANY ROLE IN THE FORMULATION OF THE NEW BUDGET PLAN LAST WEEKEND.

7. THE PRESIDENT'S POPULARITY HAS ALSO TAKEN A SHARP DOWN TURN (FROM OVER 70 PER CENT TO JUST OVER 60 PER CENT). HIS HASTILY ARRANGED TELEVISION APPEAL LAST WEEK URGING AMERICANS TO TELL THEIR CONGRESSMEN WHAT THEY THOUGHT OF THE EARLIER BUDGET PLAN BACK-FIRED BADLY. NEVERTHELESS, THE POLLS SUGGEST THAT THE AMERICAN PUBLIC AT LARGE BLAME CONGRESS AND THE PRESIDENT ABOUT EQUALLY FOR THE CURRENT DEBACLE. PUBLIC CONTEMPT FOR CONGRESS WILL UNDOUBTEDLY HAVE INCREASED, CONTRIBUTING TO THE EXISTING ANTI-INCUMBENT AND ANTI-WASHINGTON BACK LASH. THIS IS IRONIC GIVEN THAT CONGRESSMEN VOTED AGAINST THE FIRST BUDGET DEFICIT PLAN BECAUSE THEY KNEW IT WOULD BE UNPOPULAR IN THEIR DISTRICTS.

8. FOLLOWING THE FAILURE OF THE ADMINISTRATION'S ATTEMPT TO NEGOTIATE A BUDGET DEFICIT PLAN BEHIND CLOSED DOORS WITH THE CONGRESSIONAL LEADERSHIP, ACTIVITY IS NOW REVERTING TO THE NORMAL PROCEDURE. THE DIFFERENCE IS THAT THIS PROCESS NORMALLY STARTS IN MAY, AND SHOULD HAVE BEEN COMPLETED BY NOW. CONGRESS HAS ONLY UNTIL 15 OCTOBER TO PRODUCE A DETAILED FINAL PLAN FOR THE PRESIDENT TO SIGN. THIS TIMETABLE LOOKS VERY AMBITIOUS. AS SEVERAL SENIOR CONGRESSMEN HAVE COMMENTED, QUOTE THE HARD PART STARTS NOW UNQUOTE. MEANWHILE, THERE WILL BE AMPLE OPPORTUNITY FOR PARTICULAR DETAILS OF THE PACKAGE TO BE UNPICKED. THE PRESIDENT HIMSELF OUTLINED THE MAGNITUDE OF THE PROBLEM TODAY AS FOLLOWS: QUOTE THE BUDGET DEFICIT RESOLUTION BILL, DUE ON OCTOBER 12, MUST MEASURE UP TO THE SAVINGS CONGRESS HAS OUTLINED, WITHOUT SMOKE AND MIRRORS, WITH GROWTH ORIENTATED TAX INCENTIVES, WITH PROCESS REFORM, WITH ENFORCEABILITY, WITH BIPARTISAN SUPPORT, AND WITH PASSAGE BY BOTH HOUSES OF CONGRESS BY OCTOBER 19 UNQUOTE.

ACLAND

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DISTRIBUTIONADVANCE

NO 10 DOWING ST
PS/CHANCELLOR
MR ALLAN HMT
MRS LOMAX HMT

MRS M BROWN HMT
MR GREEN BANK OF ENGLAND x2
MR FAWCETT, INLAND REVENUE
RESIDENT CLERK

NNNN

RESTRICTED
ADVANCE COPY

111212
MDADAN 8518

RESTRICTED
FM WASHINGTON
TO DESKBY 051930Z FCO
TELNO 2428
OF 051730Z OCTOBER 90
AND TO IMMEDIATE TREASURY, BANK, INLAND REVENUE

RESIDENT CLERK PLEASE PASS DESKBY 051930Z TO NO. 10
FCO PLEASE ADVANCE TO NO. 10, PS/CHANCELLOR, ALLAN, MRS LOMAX,
MRS M BROWN, TREASURY. GREEN, BANK AND FAWCETT, INLAND REVENUE

US BUDGET DEFICIT

SUMMARY

BUDGET RESOLUTION IMPLEMENTING US BUDGET DEFICIT AGREEMENT VOTED DOWN BY CONGRESS. LAST MINUTE ATTEMPTS BY PRESIDENT AND CONGRESSIONAL LEADERS TO AGREE A NEW BUDGET PACKAGE FOR A NEW VOTE OVER THE WEEKEND. FAILURE WOULD MEAN TOTAL SHUT DOWN OF GOVERNMENT OR SEVERE AUTOMATIC CUTS.

DETAIL

2. IN ORDER TO ENACT THE BUDGET AGREEMENT, THE CONGRESS HAD FIRST TO PASS A BUDGET RESOLUTION SETTING OUT THE BROAD OUTLINES OF THE AGREEMENT. IF THIS HAD PASSED, IT WOULD HAVE BEEN FOLLOWED BY DETAILED LEGISLATION PUTTING THE AGREED POLICIES INTO LAW. IN FACT THE DEFICIT AGREEMENT FELL AT THE FIRST HURDLE AS THE HOUSE OF REPRESENTATIVES REJECTED THE BUDGET RESOLUTION BY 254 VOTES TO 179. NEITHER DEMOCRATS NOR REPUBLICANS SECURED A MAJORITY WITHIN THEIR RANKS FOR THE PACKAGE.

3. OPINION DIFFERS SHARPLY ON THE REASON FOR THE FAILURE, WHICH WAS CLEARLY A SUBSTANTIAL BLOW TO THE PRESIDENT AND THE DEMOCRATIC LEADERSHIP. GIVEN THE PRESIDENT'S NATIONWIDE BROADCAST OF 2 OCTOBER ARGUING STRONGLY FOR THE PACKAGE, THE BLOW TO HIS PRESTIGE IS POTENTIALLY SEVERE AND HIS STAKE IN EARLY AND CREDIBLE REMEDIAL ACTION CORRESPONDINGLY GREAT. IT WAS THE PRESIDENT'S CONCESSION ON TAX INCREASES AND, MORE IMMEDIATELY, HIS DECISION TO GIVE UP HIS DEMAND FOR A CAPITAL GAINS TAX CUT THAT PUSHED THE RIGHT WING OF THE REPUBLICANS, TO VOTE AGAINST THE PACKAGE, LED BY REP. GINGRICH.

4. THE DEMOCRATS OBJECTED STRONGLY TO THE DEEP CUTS IN MEDICARE. THEY ALSO CONSIDERED THAT THE TAX BREAKS DESCRIBED AS QUOTE GROWTH INCENTIVES UNQUOTE CONTAINED FAR TOO GENEROUS TAX

LOOPHOLES FOR THE WEALTHY. THEY ACCUSED THEIR LEADERS OF ALLOWING THEM THROUGH WITHOUT PROPER SCRUTINY IN THE FINAL HOURS OF THE NEGOTIATION. MOREOVER, FOLLOWING THE AGREEMENT, BUDGET DIRECTOR DARMAN ANNOUNCED THAT THE FIRST SET OF FIGURES GIVEN FOR DEFENCE CUTS WERE WRONG. THE DEMOCRATIC LEADERS THEN AGREED TO NEW NUMBERS WHICH APPEARED TO CUT DEFENCE BY LESS, PROVOKING LIBERAL DEMOCRAT FURY AT WHAT THEY SAW AS SHARP PRACTICE BY BUDGET DIRECTOR DARMAN.

5. ON THURSDAY 4 OCTOBER THE PRESIDENT AND DEMOCRATIC LEADERS APPEARED TO APPRECIATE THAT THE VOTE WAS IN DANGER, DESPITE VERY CONSIDERABLE ARM TWISTING ALL WEEK. SPEAKER FOLEY EMERGED FROM A MEETING WITH THE PRESIDENT SAYING THAT THE DETAILS OF THE

PACKAGE WERE QUOTE ILLUSTRATIVE UNQUOTE ONLY AND THAT, IF ONLY THE HOUSE WOULD VOTE FOR THE RESOLUTION, THE CONGRESSIONAL COMMITTEES WOULD BE ALLOWED TO ALTER THE DETAILS.

6. THIS GAVE AN IMPRESSION OF INDECISION IN THE LEADERSHIP. IT MAY HAVE PROMPTED MORE REPUBLICANS TO OPPOSE. AND THE LACK OF A REPUBLICAN MAJORITY GAVE MORE DEMOCRATS THE EXCUSE TO VOTE AGAINST.

7. BUSH AND THE DEMOCRATS MET EARLY ON OCTOBER 5 TO LOOK FOR WAYS TO REPAIR THE DAMAGE. OMB CONTACTS SAY THAT THE PRESIDENT IS QUITE CLEAR THAT HE CANNOT SIMPLY BACK DOWN AND ALLOW GOVERNMENT TO RUN NORMALLY. THE CHOICE IS BETWEEN ALLOWING A FULL SHUT DOWN OF GOVERNMENT (SINCE ALL SPENDING AUTHORITY EXPIRES AT MIDNIGHT ON 5 OCTOBER UNLESS RENEWED), OR ALLOWING A QUOTE CONTINUING RESOLUTION UNQUOTE (TEMPORARY FUNDING AT LAST YEAR'S LEVELS) ABATED BY THE AUTOMATIC GRAMM RUDMAN SEQUESTER. THIS LATTER WOULD CUT 30 PER CENT FROM DOMESTIC PROGRAMMES AND 40 PER CENT FROM DEFENCE. IT IS IN THE PRESIDENT'S TACTICAL INTEREST TO KEEP UP THE PRESSURE ON CONGRESS.

8. EVEN THE SEQUESTER WOULD MEAN THAT FLIGHTS WILL BE CANCELLED : SOCIAL SECURITY CHEQUES NOT PAID : EMPLOYMENT SERVICES SUSPENDED : FBI AND COASTGUARD SERVICES REDUCED : AND SO ON. EXPENDITURE ON DESERT SHIELD WILL BE PROTECTED. WHETHER THE PRESIDENT GOES FOR TOTAL SHUT DOWN, OR SEQUESTER, THE IMMINENCE OF THE WEEKEND (WITH A HOLIDAY ON MONDAY 8 OCTOBER) WOULD MEAN THAT THE FULL EFFECT WOULD NOT BE FELT UNTIL 9 OCTOBER. THE PRESIDENT AND CONGRESS HAVE UNTIL THEN TO FIND A NEW SOLUTION.

9. ONE OPTION IS TO STAND PAT ON THE AGREEMENT, USING THE THREAT OF FISCAL CHAOS TO FORCE THE BUDGET RESOLUTION THROUGH IN ITS PRESENT FORM. IT SEEMS MORE LIKELY HOWEVER THAT THERE WILL HAVE TO BE CHANGES IN THE RESOLUTION. MANY OF THOSE VOTING

AGAINST ON 4 OCTOBER WILL HAVE DONE SO, IN ORDER TO IMMUNISE THEMSELVES AGAINST CRITICISM FROM THEIR ELECTORAL OPPONENTS AND MAY BE PERSUADED TO CHANGE THEIR POSITION ON A SUBSEQUENT MODIFIED RESOLUTION. ALTHOUGH THE WHITE HOUSE ARE AT PRESENT SAYING THEY ARE PLANNING ON TOTAL SHUT DOWN FROM 9 OCTOBER, THAT THREAT WILL NOT BE CREDIBLE UNLESS LINKED TO SERIOUS NEGOTIATION OVER THE NEXT FEW DAYS.

10. THE OMB APPEARS TO BELIEVE THAT THE KEY IS TO RECOVER DEMOCRATIC VOTES, ON THE GROUNDS THAT THERE IS NO CREDIBLE DEAL THAT COULD GAIN THE SUPPORT OF A MAJORITY OF REPUBLICANS. THEY ARE CONTEMPLATING A REDUCTION IN THE MEDICARE CUTS, PERHAPS TO BE REPLACED BY INCREASES IN THE GAINS FROM TAX REVENUES. THIS, HOWEVER, REMAINS SPECULATION AT THIS STAGE.

ACLAND

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DISTRIBUTION

21

ADVANCE 21

.MONETARY
PS
MR BAYNE
MR MILES
HD/ERD
HD/ECD(E)
RESIDENT CLERK
NO 10.
PS/CHANCELLOR

MRS LOMAX HM TREASURY
MRS BROWN HM TREASURY
MR HADLEY, CABINET OFFICE
MR MOUNTFIELD, HMT
MR ALLAN, ROOM 108/3 HMT
MR WARE BANK OF ENGLAND
MR GREEN INLAND REVENUE
MR BANK INLAND REVENUE
MR FAWCETT INLAND REVENUE

NNNN



RESTRICTED

FM WASHINGTON

TO IMMEDIATE FCO

TELNO 2382

OF 012315Z OCTOBER 90

AND TO IMMEDIATE TREASURY, BANK, DTI, INLAND REVENUE

INFO IMMEDIATE OTTAWA, BONN, PARIS, ROME, TOKYO, ACTOR

TREASURY FOR PS/CHANCELLOR, WICKS, ALLAN, MRS LOMAX, CULPIN

BANK FOR GREEN

DTI FOR HAGESTADT

INLAND REVENUE FOR HOUGHTON, FAWCETT, CAYLEY

MY TELNOS 1927 AND 2371 (NOT TO ALL) : US BUDGET DEFICIT

SUMMARY

1. US BUDGET AGREEMENT SHOULD PUT BUDGET DEFICIT ON A DOWNWARD TREND OVER 5 YEARS. AGREEMENT NOT PERFECT (SHORT TERM DEFICIT REDUCTION FROM POLICY CHANGES OFFSET BY UPWARD REVISIONS TO DEFICIT ESTIMATES, AND THE TARGET OF BUDGET BALANCE BY 1996 LOOKS HIGHLY IMPROBABLE GIVEN WEAKNESS OF BUDGET ENFORCEMENT MECHANISM). NEVERTHELESS THE DEAL DOES INCLUDE REAL POLICY CHANGES TO TAXES AND ENTITLEMENTS WHICH SHOULD REDUCE THE DEFICIT PROGRESSIVELY IN FUTURE YEARS. THIS ACTION, AND THE 5 YEAR FOCUS, MAKES THE BUDGET DEAL MUCH BETTER THAN ITS PREDECESSORS. MARKETS SEEM TO EXPECT INTEREST RATE REDUCTIONS.

2. PRESIDENT SEEMS TO HAVE MADE THE BULK OF CONCESSIONS NECESSARY TO REACH AGREEMENT, ALTHOUGH BOTH DEMOCRATS AND REPUBLICANS ACCUSE THEIR RESPECTIVE NEGOTIATORS OF WEAKNESS. IN PRACTICE, THE NECESSARY LEGISLATION WILL PROBABLY PASS OVER THE NEXT TWO WEEKS, BUT IT WILL NOT BE PLAIN SAILING.

DETAIL

3. US BUDGET NEGOTIATORS HAVE REACHED A DEFICIT CUTTING DEAL OVER 5 YEARS AS FOLLOWS :

	1991	1992	1993	1994	1995
ORIGINAL BASELINE	231.4	205.0	135.2	79.6	76.8
ESTIMATING CHANGES					
ANNOUNCED 30/9	61.8	101.1	92.1	36.2	7.7
AGREED SAVINGS					
ANNOUNCED 30/9	-40.1	-76.7	-97.9	-132.5	-152.8
NEW DEFICIT	253.1	229.4	129.4	-16.7	-68.3
DEFICIT TARGETS	205.0	197.1	168.6	111.6	63.3

(DEFICIT TARGETS EXCLUDE SOCIAL SECURITY AND THRIFTS).

4. THE MAIN FEATURES OF THE DEFICIT CUTTING AGREEMENT ARE AS FOLLOWS :

- 1) THERE IS NO CUT IN THE US CAPITAL GAINS TAX AND NO CHANGE TO INCOME TAX RATES.
 - 2) TAX INCREASES (DOLLARS 16 BILLION IN 1991, RISING TO DOLLARS 32 BILLION BY 1995) ACCOUNT FOR 26 PER CENT OF THE REDUCTION OVER 5 YEARS : THE MAIN ITEMS ARE 10 CENTS A GALLON ON GAS, A BROADER ENERGY TAX, HIGHER ALCOHOL AND EXCISE DUTIES, LIMITS ON THE INCOME TAX DEDUCTIONS CLAIMED BY TOP EARNERS, AND INCREASES IN TAX PAID ON CERTAIN BENEFITS.
 - 3) ENTITLEMENT (DEMAND LED) PROGRAMMES ACCOUNT FOR 24 PER CENT OF THE REDUCTION (DOLLARS 12 BILLION IN 1991, RISING TO DOLLARS 34 BILLION IN 1995) : THE MAIN ITEMS ARE MEDICARE CUTS AND REDUCED AGRICULTURAL SUPPORT.
 - 4) DISCRETIONARY SPENDING (IN PRACTICE DEFENCE) ACCOUNTS FOR 36 PER CENT OF THE REDUCTION (DOLLARS 10 BILLION IN 1991, RISING TO DOLLARS 62 BILLION IN 1995).
 - 5) THE REMAINDER OF THE REDUCTIONS ARE INTEREST SAVINGS FROM A LOWER DEFICIT.
5. THE TAX MEASURES INCLUDES THE UNWELCOME (TO THE UK) EXTENSION OF INFORMATION REQUIREMENTS ON FOREIGN CORPORATIONS. BUT, MORE IMPORTANTLY, THEY EXCLUDE THE PROPOSAL TO IMPOSE A CAPITAL GAINS TAX ON FOREIGN OWNED ASSETS. CONTACTS SUGGEST THAT CONGRESSIONAL LEADERS WERE IMPRESSED BY REPRESENTATIONS (PARTICULARLY FROM THE CHANCELLOR) THAT THE UK WOULD HAVE BEEN HIT UNIQUELY HARD BY THE TAX.
6. THE DEAL INCLUDES CHANGES TO THE GRAMM RUDMAN DEFICIT TARGET LEGISLATION. FIRST, SOCIAL SECURITY SURPLUSES (INTENDED TO CREATE A RESERVE TO PAY FOR PENSIONS OF THE BABY BOOMER GENERATION) AND THE BANK AND THRIFT DEPOSIT INSURANCE FUNDS (EFFECTIVELY THE THRIFT BAIL OUT EXPENDITURE) ARE EXCLUDED FROM THE GRAMM RUDMAN DEFICIT TARGETS, AND NEW TARGETS ARE SET AS DESCRIBED ABOVE. SECONDLY, THE GRAMM RUDMAN PROCEDURE IS CHANGED. AT PRESENT, THE LAW INSISTS ON AN AUTOMATIC SEQUESTER ACROSS THE BOARD, IF THE FORECAST DEFICIT EXCEEDS THE TARGET AT THE BEGINNING OF THE FISCAL YEAR. ONCE THAT HURDLE IS PASSED, THERE IS NO FURTHER PENALTY FOR OVERSPENDING DURING THE YEAR.

- 1) OVERSPENDING DURING THE YEAR MAY RESULT IN A CLAW BACK
- 2) IT APPEARS THAT DURING FISCAL YEARS 1991-1993, ALL THE DEFICIT TARGETS FOR THE FULL 5 YEARS WILL AUTOMATICALLY BE ADJUSTED FOR CHANGES IN ECONOMIC AND TECHNICAL ASSUMPTIONS - IE ONLY OVERSPENDS ARISING FROM POLICY

CHANGES WOULD TRIGGER SEQUESTER. IF TRUE (AND A DISPUTE IS EMERGING BETWEEN ADMINISTRATION AND CONGRESS ON THIS POINT) THIS IS A SUBSTANTIAL WEAKENING OF THE PROCEDURE.

3) FOR FISCAL YEARS 1994-95 THE DEFICIT TARGETS AS THEY HAVE BY THEN BECOME AFTER ADJUSTMENTS AS AT (2) ABOVE, WILL NO LONGER BE ADJUSTED FOR CHANGES IN ASSUMPTIONS AND WILL APPLY AS AT PRESENT, TO OVERSPENDS ARISING FROM ECONOMIC AND

4) ANY OVERSPENDING ON APPROPRIATIONS WILL RESULT IN AN AUTOMATIC CUT IN APPROPRIATIONS. ANY POLICY CHANGES TO TAX MEASURES OR ENTITLEMENTS MUST BE ACCOMPANIED BY

7. THE BUDGET AGREEMENT INCLUDES THE PROCEDURE AND TIMETABLE FOR ENACTMENTS. AS SOON AS THE BUDGET AGREEMENT WAS ANNOUNCED, CONGRESS PASSED A TEMPORARY QUOTE CONTINUING RESOLUTION UNQUOTE (CR), TO FUND THE GOVERNMENT AND SUSPEND THE GRAMM RUDMAN SEQUESTER FROM 1 OCTOBER (THE BEGINNING OF THE FISCAL YEAR) TO 5 OCTOBER. THE CR WILL ONLY BE RENEWED IF CONGRESS HAS PASSED A BUDGET RESOLUTION INCORPORATING THE AGREEMENT INTO THE NORMAL BUDGET PROCEDURE. A FURTHER 2 WEEK CR WILL THEN BE PASSED, TO GIVE TIME FOR ALL THE LEGISLATIVE CONSEQUENCES OF THE DEAL TO BE ENACTED BY 19 OCTOBER. THE SECOND CR WILL ALSO RAISE THE DEBT CEILING. THE LIMIT ON FEDERAL BORROWING EXPIRES ON 2 OCTOBER, BUT THE TREASURY CAN SCRAPE THROUGH THE WEEK WITHOUT ISSUING MORE BONDS.

8. THE MARKETS APPEAR TO APPROVE THE DEAL. YIELDS ON LONG BONDS DECLINED FROM 9.14 PER CENT ON 26 SEPTEMBER TO 8.83 PER CENT (MIDDAY 1 OCTOBER) IN ANTICIPATION OF AND THEN CONFIRMATION OF A DEAL. THE DOLLAR WEAKENED IN EXPECTATION OF FURTHER FEEDING OF RATES. THE FED IS MEETING TO CONSIDER THIS QUESTION THIS WEEK. ALTHOUGH LOGICALLY THEY OUGHT TO WAIT UNTIL A DEAL IS ENACTED INTO LAW, FED STAFF CONSIDERED THAT THEY WOULD BE UNDER ENORMOUS PRESSURE TO ACT MORE QUICKLY.

COMMENT

9. AS ANNOUNCED, THE AGREEMENT CLEARLY HAS SOME FLAWS. FOR THE FIRST YEAR, FORECASTING INCREASES IN THE DEFICIT WIPE OUT THE EFFECT OF POLICY REDUCTIONS. THE ENFORCEMENT MEASURES FOR FUTURE YEARS ARE DISAPPOINTINGLY WEAK, AND THERE ARE DOUBTS ABOUT WHETHER ALL THE MEASURES NECESSARY TO ACHIEVE THE TARGET SAVINGS HAVE REALLY BEEN AGREED. NEVERTHELESS, THE DEAL STILL LOOKS A LOT BETTER THAN ANY OF ITS PREDECESSORS :

1) TAX CHANGES AND POLICY REDUCTIONS IN ENTITLEMENTS, ONCE IN PLACE, WILL CONTINUE TO PRODUCE DEFICIT SAVINGS IN FUTURE YEARS, WITHOUT FURTHER CONGRESSIONAL ACTION.

2) FOR DEFENCE, AND OTHER DISCRETIONARY SPENDING, THE ENFORCEMENT PROCEDURE AUTOMATICALLY IMPOSES CUTS IF FUTURE

POLICY CHANGES INCREASES SPENDING.

3) THE DEAL COVERS 5 YEARS, AND THEREFORE DOES NOT INCLUDE THE PAYMENT SHIFTS, OVERTIME SAVINGS AND OTHER FIDDLES WHICH HAVE BEEN INCLUDED IN PREVIOUS BUDGET AGREEMENTS.

ON BALANCE THE DEAL, IF ENACTED, SHOULD PRODUCE A DOWNWARD TREND IN THE DEFICIT.

10. ENACTMENT, HOWEVER, IS NOT IN THE BAG. THE PRESIDENT APPEARS TO HAVE GIVEN THE MOST GROUND. THERE IS NO CAPITAL GAINS TAX REDUCTION. HE HAS CONCEDED TAX INCREASES. ENFORCEMENT IS WEAKER, NOT STRONGER. REPUBLICAN CONGRESSMEN LED BY REP GINGRICH ARE ALREADY COMPLAINING LOUDLY. ON THE OTHER HAND WE UNDERSTAND THAT DEMOCRATIC CONGRESSMEN WERE BITTERLY CRITICAL OF MANY ASPECTS OF THE DEAL : ITS ALLEGED REGRESSIVITY (WITH EXCISE AND GAS TAX INCREASES FOR LOW INCOME GROUPS AND SOME TAX BREAKS FOR HIGHER INCOME EARNERS), INSUFFICIENT DEFENCE CUTS AND EXCESSIVE MEDICARE CUTS. THE LEVEL OF ANGER IS INCREASED BY THE FACT THAT THERE IS ALREADY SOME DISAGREEMENT ABOUT WHAT WAS AND WAS NOT INCLUDED IN THE BUDGET DEAL AND INEVITABLE ACCUSATIONS OF BAD FAITH.

11. THE CRIES OF PAIN EMPHASISE THAT THE DEAL IS A REAL ONE. IT WILL BE CORRESPONDINGLY HARD TO ENACT. BUSH AND CONGRESSIONAL LEADERS WILL NOW ENGAGE IN EXTENSIVE ARM TWISTING TO GET FIRST THE BUDGET RESOLUTION AND THEN THE LEGISLATION INTO LAW. DEMOCRATS HAVE INSISTED THAT A MAJORITY OF BOTH PARTIES IN BOTH HOUSES OF CONGRESS MUST SUPPORT THE PACKAGE. ALTHOUGH THEY MAY SOFTEN ON THAT, THERE IS STILL NO GUARANTEE THAT EVEN A REASONABLE MINORITY OF REPUBLICANS WILL SUPPORT IT. THE SITUATION IS INHERENTLY UNSTABLE IN THAT FOR EACH CONGRESSMAN, IT IS TO HIS OR HER ADVANTAGE TO OPPOSE, SO LONG AS A MAJORITY SUPPORT.

12. IN THE END, THERE IS LIKELY TO BE A MAJORITY FOR THE RESOLUTION AND LEGISLATION, ALTHOUGH THERE WILL BE MUCH BRINKMANSHIP AND PERHAPS ONE OR TWO FAILED ATTEMPTS.

13. IF THE DEAL IS ENACTED, THERE WILL STILL BE A DEFICIT OUTTURN OF DOLLARS 250 BILLION OR MORE IN FY91. THIS WOULD BE THE HIGHEST NOMINAL BUDGET DEFICIT THE US (AND INDEED ANY COUNTRY) HAS EVER RUN, ALTHOUGH STILL BELOW THE US PEAK AS A PERCENTAGE OF GNP. FOR THE FUTURE, THERE IS A GOOD PROSPECT OF REAL REDUCTIONS IN US DEMANDS ON THE WORLD CREDIT MARKETS AND THE PROSPECTS FOR THE DEFICIT RETURNING TO SUSTAINABLE LEVELS LOOK SUBSTANTIALLY BETTER.

ACLAND

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MDHIAN 8697

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FM WASHINGTON

TO IMMEDIATE FCO

TELNO 2208

OF 122110Z SEPTEMBER 90

AND TO IMMEDIATE TREASURY, BANK OF ENGLAND

FCO PLEASE ADVANCE TO PS/CHANCELLOR, ALLAN, GRAY, TSY

AND TO GREEN, BANK

MY TELNO 1823 : US MONETARY POLICY

SUMMARY

SOME EASING OF US MONETARY STANCE NOW SEEMS POSSIBLE IN THE NEAR FUTURE. A CRITICAL DATE IS FRIDAY 14 SEPTEMBER WHEN IMPORTANT ECONOMIC DATA IS ISSUED AND BY WHEN (ACCORDING TO SOME SPECULATION) A BUDGET DEAL MIGHT BE STRUCK. EITHER FURTHER CONVINCING EVIDENCE OF A WEAKENING ECONOMY, OR A CREDIBLE BUDGET DEAL WOULD PROBABLY PROMPT A REDUCTION IN FED FUNDS RATE.

DETAIL

2. FED STAFF HAVE TOLD US THAT THEY WERE CONCERNED THAT THE QUARTER POINT REDUCTION IN THE FED FUNDS RATE IN EARLY JULY WAS INTERPRETED AS A WEAKENING IN THE FED'S ANTI INFLATION RESOLVE, AND A RESPONSE TO POLITICAL PRESSURE. THIS MADE FURTHER EASING MORE DIFFICULT. HOWEVER, THE ABSENCE OF ANY MOVEMENT SINCE THEN, DESPITE THE MOUNTING EVIDENCE THAT THE ECONOMY IS SLOWING DOWN SHARPLY, HAS (IN THE FED'S VIEW) ALMOST COMPLETELY RESTORED THEIR ANTI INFLATION CREDIBILITY IN THE EYES OF THE MARKETS.

3. COMMENTING ON THE APPROPRIATE RESPONSE TO THE OIL PRICE INCREASE (AND THE CONSEQUENT DETERIORATION IN BOTH GROWTH AND INFLATION PROSPECTS), FED STAFF RULED OUT ANY SERIOUS POSSIBILITY OF AN INCREASE IN THE FED FUNDS RATE. THEY ACKNOWLEDGED THAT AN INCREASE IN INFLATIONARY EXPECTATIONS AS A RESULT OF THE OIL PRICE INCREASE WOULD MEAN THERE WOULD BE AN EFFECTIVE EASING OF THE MONETARY STANCE UNLESS THE FED FUNDS RATE WERE RAISED. BUT THEY ARGUED THAT LONG TERM INFLATIONARY EXPECTATIONS WOULD NOT IN FACT INCREASE (IE THE OIL PRICE INCREASE WOULD BE SEEN AS TEMPORARY). EVEN IF THIS WERE NOT SO, THE REDUCTION IN DEMAND AS A RESULT OF THE OIL PRICE WOULD MORE THAN JUSTIFY THE EFFECTIVE EASING OF POLICY IMPLIED BY A CONSTANT FED FUNDS RATE IN THESE CIRCUMSTANCES.

4. FED STAFF ALSO ACKNOWLEDGED THE LOGIC OF STICKING TO EXISTING POLICY GIVEN THAT THE OIL PRICE RISE WOULD SIMPLY ALTER THE BALANCE OF INFLATION AND GROWTH IN THE RISE IN NOMINAL GNP. THIS VIEW WAS ALSO RECENTLY ADVANCED BY GOVERNOR ANGELL.

HOWEVER, IT SEEMED LIKELY THAT THIS WOULD NOT BE A MAJORITY VIEW ON THE FED BOARD. AND FED STAFF QUICKLY POINTED OUT THAT, EVEN IF ACCEPTED, THIS LOGIC IMPLIED KEEPING THE FED FUNDS RATE AT THE LEVEL IT WOULD OTHERWISE HAVE BEEN, WITHOUT THE OIL PRICE INCREASE, NOT NECESSARILY THE LEVEL IT IS NOW.

5. NOTING THAT THE US DOLLAR HAD WEAKENED ON 11 SEPTEMBER, THE FED POINTED OUT THAT, NEVERTHELESS, THERE DID NOT APPEAR TO BE ANY SIGNIFICANT EXPECTATION OF LOWER US INTEREST RATES IN THE FUTURES MARKETS. THEY ALSO NOTED THAT THE DOLLAR ON A WEIGHTED AVERAGE WAS HIGHER THAN AT THE LAST FOMC MEETING. ALTHOUGH A FACTOR IN FED POLICY, FED STAFF DID NOT THINK THE RISK OF A FALL IN THE US DOLLAR WOULD OVERRIDE ANY DECISIONS TO EASE POLICY. GOVERNOR ANGELL WAS CLEAR THAT NO DEPRECIATION WAS JUSTIFIED, BUT WHEN THE ECONOMY WAS AS WEAK AS IT NOW APPEARS, THIS CONCERN WAS NOT SHARED BY OTHER FED GOVERNORS.

6. THE FED TOOK THE VIEW THAT THE MARKETS HAD NOT DISCOUNTED A SOLID AND CREDIBLE BUDGET DEAL. THE US PRESS WAS REPORTING A SUBSTANTIAL INCREASE IN OPTIMISM IN THE BUDGET TALKS. IF THIS PROVED JUSTIFIED, FED STAFF THOUGHT THERE WOULD CERTAINLY BE GROUNDS FOR A REDUCTION IN THE FED FUNDS RATE. PRESS SPECULATION SUGGESTED A DEAL WITHIN DAYS, POSSIBLY BY FRIDAY 14 SEPTEMBER.

7. ALSO ON 14 SEPTEMBER, DATA WILL BE RELEASED ON INDUSTRIAL PRODUCTION, CAPACITY UTILISATION, RETAIL SALES AND PRODUCER PRICES. THAT DATA WILL CLEARLY BE STUDIED VERY CAREFULLY BY THE FED FOR EVIDENCE OF FURTHER WEAKENING OF THE ECONOMY.
COMMENT

8. THE FED IS VERY CAREFUL NOT TO COMMENT DIRECTLY ON PROSPECTS FOR INTEREST RATES. BUT THEY FIRMLY RULED OUT ANY POSSIBILITY OF RAISING THE FED FUNDS RATE AND POINTED TO A NUMBER OF FACTORS SUGGESTING EASING. A BUDGET DEAL, OR A SET OF WEAK ECONOMIC DATA ON 14 SEPTEMBER, COULD BE THE TRIGGER. IT REMAINS TRUE THAT THERE IS A CONTINUING DANGER THAT IF THE FED REDUCES SHORT TERM RATES, FEARS ABOUT INFLATION WILL BE INCREASED AND HENCE LONG TERM INTEREST RATES WILL ALSO RISE, OR THAT THE US DOLLAR WILL WEAKEN. NEVERTHELESS, AT PRESENT, IT LOOKS AS THOUGH THE FED IS PREPARING TO TAKE THE RISK, AND THAT SOME DOWNWARD MOVE IN THE FED FUNDS RATE IS POSSIBLE SOON, UNLESS ECONOMIC DATA SHOWS UNEXPECTED STRENGTH IN THE ECONOMY.

ACLAND

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RESTRICTED

FM WASHINGTON

TO IMMEDIATE FCO

TELNO 1755

OF 262110Z JULY 90

AND TO IMMEDIATE TREASURY, BANK, INLAND REVENUE

*Refer to
your meeting with
in President
an*

ADVANCE TO MELLISS, ALLAN AND MRS LOMAX, TREASURY

ADVANCE TO GREEN, BANK

ADVANCE TO CAYLEY, INLAND REVENUE

MY TELNO 1661: US BUDGET DEFICIT

SUMMARY

1. ATMOSPHERE IN US BUDGET TALKS TURN SOUR. SOME GROUND CLEARED BUT MORE DISAGREEMENTS REVEALED. BUSH TRIES TO REVIVE TALKS BY STARTING A NEW SMALLER GROUP. PROSPECTS FOR AGREEMENT BEFORE RECESS HAVE DIMMED.

DETAIL

2. THE BOOST GIVEN TO THE BUDGET DEFICIT TALKS BETWEEN CONGRESSIONAL AND ADMINISTRATOR LEADERS BY THE PRESIDENT'S CONCESSION ON TAXES APPEARS TO HAVE BEEN VERY TEMPORARY. ALTHOUGH ALL CONCERNED REPORTED AN IMPROVEMENT IN THE ATMOSPHERE AFTER THE PRESIDENT'S STATEMENT, MOST OBSERVERS NOW AGREE THAT THERE HAS BEEN A DETERIORATION. THE PARTICIPANTS HAVE RESUMED THEIR PRACTICE OF MAKING LONG SPEECHES WHICH ARE EITHER BANAL OR PARTISAN. THERE IS A CONSIDERABLE DEGREE OF FINGER POINTING AND ACCUSATIONS OF BAD FAITH BETWEEN THE DIFFERENT PARTICIPANTS. THE DEMOCRATS SAY THEY WANT A NEW PRESIDENTIAL INITIATIVE INVOLVING A STATEMENT TO THE PUBLIC ABOUT THE DEPTH OF THE BUDGET CRISIS. THE REPUBLICANS WANT A DEMOCRATIC RESPONSE TO THE PRESIDENT'S CONCESSION ON TAXES.

3. IN ORDER TO RESTART THE NEGOTIATIONS, THE PRESIDENT HAS FORMED A NEW SMALLER GROUP. THIS CONSISTS OF SENATE MAJORITY LEADER MITCHELL, SPEAKER FOLEY, HOUSE MAJORITY LEADER GEPHARDT, SENATE MINORITY LEADER DOLE AND HOUSE MINORITY LEADER MICHEL. THEY ARE JOINED BY BRADY, DARMAN AND THE PRESIDENT. THIS LATTER GROUP IS SAID TO BE PREPARING TO EXCHANGE SPECIFIC PACKAGES OF PROPOSALS DESIGNED TO REDUCE THE BUDGET DEFICIT. WHILE SUCH AN EXCHANGE MAY INDEED BE IMMINENT, IT IS UNLIKELY TO LEAD TO EARLY AGREEMENT.

4. THERE HAS BEEN A SMALL AMOUNT OF GROUND CLEARED SINCE THE PRESIDENT'S CONCESSION ON TAXES. IT IS NOW MORE OR LESS AGREED THAT:

1) THE AGREEMENT MUST BE A FIVE-YEAR AGREEMENT REDUCING THE

DEFICIT BY DOLLARS 50 BN IN THE FIRST YEAR AND BY DOLLARS 500 BN OVER 5 YEARS.

- II) IN THE FIRST YEAR HALF OF THE DEFICIT REDUCTION WOULD BE FROM REVENUES AND HALF FROM SPENDING.
- III) EXPENDITURE ON THRIFTS AND SOCIAL SECURITY WILL BE TAKEN OFF THE BUDGET.

5. HOWEVER, THIS AREA OF AGREEMENT HAS REVEALED TOUGH NEW DIVISIONS BETWEEN THE PARTICIPANTS SPECIFICALLY CONCERNING THE PROBLEM OF HOW TO ENFORCE THE MULTI-YEAR AGREEMENT, AND HOW TO BREAK DOWN THE DOLLARS 500 BN DEFICIT CUTS OVER FIVE YEARS BETWEEN SPENDING AND TAXES.

6. TO ENFORCE THE DEAL, OMB TELL US THAT THEY ARE PREPARING A SERIES OF MEASURES. FIRST, THERE WILL BE TARGETS IN TERMS OF BUDGET AUTHORITY AND CASH OUTLAY FIGURES FOR EACH OF THE FIVE YEARS FOR DEFENCE SPENDING, DOMESTIC DISCRETIONARY SPENDING, INTERNATIONAL SPENDING, ENTITLEMENTS (DEMAND LED PROGRAMMES) AND REVENUES. IF THE TOTAL APPROPRIATIONS FOR ANY ONE OF THE RELEVANT CATEGORIES EXCEEDED THE TARGET IN ANY ONE YEAR, THE PRESIDENT WOULD BE ALLOWED TO STRIKE OUT SPENDING FROM THE RELEVANT APPROPRIATIONS BILLS UP TO THE AMOUNT OF THE EXCESS OVER TARGET. CONGRESS COULD ONLY OVERRULE THE PRESIDENT WITH A TWO-THIRDS MAJORITY. IF ECONOMIC ASSUMPTIONS PUSHED ENTITLEMENTS AND REVENUE ESTIMATES BEYOND THE TARGET IN THE AGREEMENT, THEN THE GRAMM RUDMAN SEQUESTER WOULD COME INTO PLAY AS NOW. HOWEVER THERE WILL BE ENHANCEMENT TO THAT PROCEDURE INVOLVING A SECOND SEQUESTER HALF WAY THROUGH THE YEAR WHICH WILL BE TRIGGERED IF FORECASTS THEN SUGGEST THAT THE TARGETS FOR THE YEAR AS A WHOLE WOULD BE EXCEEDED. THE ESSENTIAL POINT OF THESE CHANGES WOULD BE TO ENSURE THAT THE DEFICIT COULD ONLY BE EXCEEDED EITHER WITH THE PRESIDENT'S EXPLICIT APPROVAL, OR IF HE WERE OVERRULED BY A TWO-THIRDS MAJORITY IN CONGRESS.

7. MANY OF THESE PROPOSALS WOULD BE VERY DIFFICULT FOR MANY CONGRESSMEN TO ACCEPT - NOT SIMPLY ON THE DEMOCRATIC SIDE.

8. BOTH SIDES HAVE AGREED RELATIVELY EASILY ON A HIGH FIGURE FOR THE TOTAL DEFICIT CUT OVER FIVE YEARS. THE DEMOCRATS WANTED A BIG NUMBER OVER THAT PERIOD IN ORDER TO MAKE IT DIFFICULT FOR THE PRESIDENT TO INSIST ON A CAPITAL GAINS TAX CUT (WHICH GAINS REVENUES IN THE EARLY YEARS BUT LOSES THEM OVER FIVE YEARS). THE REPUBLICANS HAVE WANTED A HIGH FIGURE SINCE THEY BELIEVE IT WOULD FORCE THE DEMOCRATS TO ACCEPT DEEP ENTITLEMENT CUTS. THUS THE EASE OF AGREEMENT ON THE OVERALL FIGURES DOES NOT SIGNIFY SIMPLE AGREEMENT TO THE SPECIFICS OF THE PACKAGE.

9. THE SUMMIT ALSO HAS TO DECIDE HOW SPECIFIC TO BE WITHIN EACH OF THE CATEGORIES LISTED ABOVE. ON TAXES, FOR EXAMPLE, IT IS

INEVITABLE THAT THE TAX-WRITING COMMITTEES WILL WISH TO RAISE TAXES BY MORE THAN THE FIGURE REQUIRED FOR DEFICIT REDUCTION, THUS ALLOWING ROOM FOR SWEETENERS IN THE FORM OF TAX CUTS. IT IS LIKELY THAT THERE WILL BE AGREEMENT ON BOTH A GROSS AND A NET REVENUE FIGURE. BUT THE HIGHER THE GROSS FIGURE, THE MORE LIKELY THE TAX-WRITING COMMITTEES ARE TO COME UP WITH TAXES THAT ARE UNACCEPTABLE TO THE PRESIDENT. WHILE THE PRESIDENT AND THE REPUBLICANS WOULD LIKE TO BE HIGHLY SPECIFIC IN WHICH TAXES TO INSTRUCT THE TAX-WRITING COMMITTEES TO WRITE, THOSE COMMITTEES WOULD THEMSELVES RESIST EXCESSIVE PRESCRIPTIONS.

10. WHILE THE NEW AREAS OF DISAGREEMENT ARE BEING REVEALED, IT IS BECOMING INCREASINGLY DIFFICULT TO SEE HOW A DEAL CAN BE BROUGHT TOGETHER. THERE ARE NOW, EFFECTIVELY, TWO SUMMIT GROUPS. THE LARGER WITH SOME 25 PARTICIPANTS, INCLUDE THE CHAIRMEN OF MOST OF THE MAJOR CONGRESSIONAL COMMITTEES. HOWEVER, IT IS QUITE CLEAR THAT THOSE PRESENT AT THE LARGER SUMMIT CANNOT COMMIT THE TOP CONGRESSIONAL LEADERSHIP. NOR CAN THE REPUBLICANS AT THE SUMMIT COMMIT THE PRESIDENT. ON THE OTHER HAND THE SMALL SUMMIT GROUP WHICH THE PRESIDENT HAS CONVENED CANNOT ITSELF DELIVER THE AGREEMENT OF THE LARGER GROUP.

COMMENT

11. AS IS FREQUENTLY THE CASE WITH BUDGETARY MATTERS, IT WILL REQUIRE SOME FORM OF CRISIS TO BREAK THIS LOG JAM. BARRING A FURTHER COLLAPSE IN THE STOCK MARKET, THE MOST LIKELY CRISIS WOULD BE A FISCAL PROBLEM BROUGHT ON BY THE TRIGGERING OF A SEQUESTER. BECAUSE THE SEQUESTER WOULD BE SO BIG AND SO DEVASTATING (CUTTING 38 PER CENT OF DOMESTIC PROGRAMMES AND AT LEAST 25 PER CENT ON DEFENCE) MANY HAVE ARGUED THAT THE PRESIDENT WOULD NOT SIGN THE SEQUESTER ORDER. OUR OMB CONTACTS, HOWEVER, INSIST PRIVATELY THAT THE ADMINISTRATION IS PREPARING TO GO AHEAD WITH THE SEQUESTER. PLANS FOR IMPLEMENTING IT ARE NOW BEING DRAWN UP AND WILL BE MADE PUBLIC. THUS WITHIN THE NEXT FEW WEEKS, ANNOUNCEMENTS WILL BE MADE, FOR EXAMPLE, ABOUT THE NUMBER OF FLIGHTS THAT WOULD HAVE TO BE CANCELLED ONCE THE AIR TRAFFIC CONTROL STAFF ARE SENT HOME IF A SEQUESTER IS TRIGGERED IN OCTOBER. OMB ALSO SAY THAT ALTHOUGH THEY WILL BE DELIBERATELY RAISING THE STAKES IN THIS WAY, IN PRACTICE, EVEN IF THEY WISHED TO, THEY WILL BE UNABLE TO MANAGE THE SEQUESTER WITHOUT SEVERE DISRUPTION FOR MORE THAN A MATTER OF TWO OR THREE WEEKS. THUS WE ARE LIKELY TO SEE STRONG SIGNALS FROM THE ADMINISTRATION THAT, WITHOUT AN AGREEMENT, THERE WILL BE VERY SEVERE DISRUPTION TO PUBLIC PROGRAMMES SOME TIME IN OCTOBER. THAT MIGHT FORCE AN AGREEMENT.

12. ONCE THE DEAL IS STRUCK, IT IS UNLIKELY THAT CONGRESSMEN

WILL WISH TO STAY IN WASHINGTON TO IMPLEMENT THE LEGISLATION, SINCE THEY WILL NEED TO CAMPAIGN FOR RE-ELECTION ON 6 NOVEMBER. THE DEAL WOULD THEREFORE HAVE TO BE PUT INTO LEGISLATIVE FORM IN A QUOTE LAME DUCK UNQUOTE SESSION IN DECEMBER. STRICTLY SPEAKING, THIS SHOULD MEAN THAT THE GRAMM-RUDMAN SEQUESTER WOULD BE IMPLEMENTED. HOWEVER, IF A REASONABLY CREDIBLE DEAL IS STRUCK IN PRINCIPLE IN OCTOBER, CONGRESS COULD VOTE TO SUSPEND THE GRAMM-RUDMAN SEQUESTER. THAT SEEMS THE MOST LIKELY OUTCOME. 13. THE INCREASED DIFFICULTY IN REACHING AGREEMENT NOW REINFORCES THE VIEW THAT THERE WILL BE A SIGNIFICANT AMOUNT OF ACCOUNTING TRICKS WITHIN THE BUDGET DEFICIT AGREEMENT. THE OMB'S LATEST ESTIMATE FOR THE BUDGET DEFICIT, WITHOUT ANY POLICY CHANGES, IS ABOUT DOLLARS 230 BN (INCLUDING THRIFTS) OR DOLLARS 160 BN (EXCLUDING THRIFTS). IT IS UNLIKELY THAT WE WILL SEE A DEAL STRONG ENOUGH TO BRING THESE FIGURES DOWN BELOW DOLLARS 190-200 BN AND DOLLARS 130 BN RESPECTIVELY.

WOOD

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TREASURY FOR MELLIS, WALSH GRAY
BANK FOR ILES
GREENSPAN AT HUMPHREY-HAWKINS
SUMMARY

1. GREENSPAN DENIES THERE IS A QUOTE CREDIT CRUNCH UNQUOTE BUT ACCEPTS THAT CREDIT CONDITIONS HAVE TIGHTENED. QUESTIONING REVEALED SOME AMBIGUITY ABOUT THE REASONS FOR THE EASING OF MONETARY CONDITIONS ON 13 JULY. BANKING COMMITTEE PRIMARILY CONCERNED ABOUT FRAGILITY OF BANKING SYSTEM AND SCORING POINTS ON THE BUDGET DEFICIT.

DETAIL

2. GREENSPAN GAVE HIS TWICE YEARLY HUMPHREY-HAWKINS TESTIMONY TO THE SENATE BANKING COMMITTEE ON 18 JULY. HE DEVOTED HIS TESTIMONY TO THE PROGRESS OF THE ECONOMY, THE CREDIT CRUNCH AND THE NEED FOR A CUT IN THE DEFICIT.

3. HE WAS POSITIVE ABOUT THE ECONOMY. 2 PER CENT GROWTH IN Q1 HAD SLOWED IN THE SECOND QUARTER BUT THE PROSPECT OF RECESSION SEEMED LOW. EXPORTS AND INDUSTRIAL PRODUCTION WERE DOING WELL, BUT HOUSING WAS SOFTENING AND CONSUMER CONFIDENCE FLAGGING A LITTLE. GROWTH FOR 1990 LIKELY TO BE 1 1/2 TO 2 PER CENT. INFLATION STILL TOO HIGH, BUT THE INCREASE OF 0.5 PER CENT ANNOUNCED ON 18 JULY WAS AN ABERRATION AND THE PROSPECT FOR THE YEAR WAS 4 1/2-5 PER CENT.

4. ALTHOUGH EMPLOYMENT GROWTH WAS LOW, UNEMPLOYMENT WAS ALSO LOW, SUGGESTING A FALL AWAY IN LABOUR FORCE PARTICIPATION RATES AS JOB SEEKERS BECAME DISCOURAGED AND LEFT THE LABOUR MARKET. IT WAS TOO EARLY TO TELL WHETHER A NEW TREND WAS STARTING BUT THE LABOUR MARKET DATA DEMANDED ATTENTION, GREENSPAN SAID.

5. IN DETERMINING POLICY THE SHORT TERM RISKS OF INFLATION AND RECESSION WERE EVENLY BALANCED. UNDER CLOSE QUESTIONING FROM SENATOR SARBANES (DEM, MARYLAND), GREENSPAN CONCEDED THAT THE BALANCE HAD SHADED TOWARDS RECESSION. AFTER REPORTERS RUSHED FOR THE DOOR ON HEARING THIS, GREENSPAN CLARIFIED BY SAYING THAT THE EASING OF POLICY ON 13 JULY HAD CORRECTED FOR THIS SLIGHT CHANGE IN OUTLOOK. OVERALL, THE ECONOMY WAS IN AS GOOD A SHAPE AS COULD BE

EXPECTED.

6. THE BULK OF GREENSPAN'S TESTIMONY WAS DEVOTED TO THE ALLEGED CREDIT CRUNCH. HE ARGUED THAT THERE WAS ACCUMULATING EVIDENCE (WIDENING MARGINS BETWEEN BANK BORROWING AND LENDING RATES, INCREASING REPORTS OF CHANGES IN BANK LENDING POLICY AND PRACTICE, AND A DECLINE IN MONETARY AGGREGATES) OF A SLOWDOWN IN THE RATE OF CREDIT EXPANSION.

7. GREENSPAN POINTED TO 2 FACTORS THAT PARTIALLY EXPLAINED THIS EVIDENCE. FIRST LONG TERM INTEREST RATES WERE HIGHER. SECONDLY, THE AVAILABILITY OF LARGE BLOCKS OF DEPOSITS FROM FAILED THRIFTS, AND THE CAUTION BY DEPOSIT TAKING INSTITUTIONS ALLOWED THEM TO AVOID RAISING INTEREST RATES ON DEPOSITS. DEPOSITORS THEREFORE LOOKED ELSEWHERE FOR SAVINGS INSTRUMENTS AND THIS REDUCED M2. BUT THESE FACTORS COULD NOT ENTIRELY EXPLAIN THE SPEED AND DEPTH OF M2 FALL. IN PRACTICE, CREDIT INSTITUTIONS HAVE REINED IN LENDING ACTIVITY AND IMPOSED STIFFER TERMS ON LOANS. WHILE THIS WAS NOT A QUOTE CREDIT CRUNCH UNQUOTE, GREENSPAN SAID IT WAS A MODEST SLOWDOWN IN CREDIT EXPANSION.

8. GREENSPAN ASSERTED STRONGLY THAT A SLOWDOWN IN THE PREVIOUSLY UNHEALTHY RATE OF CREDIT EXPANSION WAS A GOOD THING. BUT THERE WAS A DIVIDING TIME BETWEEN THAT AND EXCESSIVE RESTRICTION. QUOTE IN RECENT WEEKS, HOWEVER, WE MAY HAVE SLIPPED OVER THAT LINE UNQUOTE. GREENSPAN THOUGHT THAT CREDIT TIGHTENING MAY CONTINUE AND THEN UNWIND. THE FED'S ACTION ON 13 JULY WAS AT PRESENT CONSIDERED ADEQUATE TO OFFSET THE EXCESSIVE TIGHTENING.

9. THE MONETARY RANGES WERE AMENDED AS FOLLOWS:

	1990	1991
M2	3 - 7	2 1/2 - 6 1/2
M3	1 - 5	1 - 5
DEBT	5 - 9	4 1/2 - 8 1/2

GREENSPAN SAID THAT MODERATE GROWTH IN M2 WAS CONSISTENT WITH A GROWING ECONOMY. A REDUCTION IN M3 RANGES (THE 1990 RANGE WAS REDUCED TO 1 - 5 FROM 2 1/2 - 6 1/2) WAS MADE NECESSARY BY THE SHARP REDUCTION IN THRIFT DEPOSITS.

10. GREENSPAN CONCLUDED BY EMPHASISING THE IMPORTANCE OF A REDUCTION IN THE BUDGET DEFICIT. HE SAID THAT WHILE NO COMMITMENT ON INTEREST RATES WAS POSSIBLE, QUOTE THE FEDERAL RESERVE WILL ACT, AS IT HAS IN THE PAST, TO ENDEAVOUR TO KEEP THE ECONOMIC EXPANSION ON TRACK UNQUOTE.

11. IN QUESTIONING SENATORS DEMONSTRATED CONCERN ABOUT THE STATE OF THE DEPOSIT INSURANCE FUND FOR BANKS (THE PRESENT RESERVE IS 0.7 PER CENT OF TOTAL DEPOSITS AND FALLING). CHAIRMAN RIEGLE AND SENATOR KERRY (D.-MASSACHUSETTS) ASKED WHETHER A REPEAT OF THE S AND L CRISIS WAS IN THE OFFING. GREENSPAN DENIED THIS, BUT

EMPHASISED THE NEED FOR MORE CAPITAL.

12. OTHER QUESTIONERS PRESSED GREENSPAN ON WHY THE BUDGET DEFICIT WAS WORSE, ON THE NEED TO INCREASE SAVINGS, THE EFFECT OF A DEFICIT REDUCTION PACKAGE ON INTEREST RATES, AND THE INFLUENCE OF FOREIGN CREDITORS ON THE ECONOMY. GREENSPAN'S ANSWERS WERE NON-COMMITTAL.

COMMENT

13. GREENSPAN APPEARED SURPRISINGLY ILL AT EASE. HE WAS CLEARLY RATTLED BY THE CLOSE QUESTIONING OF SENATOR SARBANES, WHO WAS THE ONLY ONE TO PUSH HIM AT ALL ON THE FED'S VIEW OF THE STATE OF THE ECONOMY. HE WAS FORCED INTO CONCEDED THAT THE RISK OF RECESSION HAD RISEN BY A SHADE.

14. ALTHOUGH HE SUBSEQUENTLY CORRECTED HIMSELF, HIS PERFORMANCE SUGGESTED A LACK OF CONFIDENCE IN THE OFFICIAL EXPLANATION FOR THE 13 JULY EASING OF CREDIT CONDITIONS. HIS TESTIMONY ASSERTED THAT IT WAS TO OFFSET THE CREDIT TIGHTENING CURRENTLY OCCURRING SPONTANEOUSLY IN THE ECONOMY. BUT HIS ANSWERS TO QUESTIONS SUGGESTED THAT SOME SOFTENING IN THE ECONOMY WAS OCCURRING, WHICH REQUIRED RELAXATION OF MONETARY CONDITIONS. SIMILAR AMBIGUITY HAS BEEN DETECTED IN OUR PRIVATE CONVERSATIONS WITH FED STAFF. WE HAVE ALSO ESTABLISHED THAT THE DECISION TO ANNOUNCE, ON 12 JULY, AN EASING OF CONDITIONS, WAS NOT THE SUBJECT OF A CONSENSUS IN THE FED. MANY DID NOT KNOW IN ADVANCE. AND IT IS ODD THAT GREENSPAN SHOULD MOVE FROM A DENIAL OF ANY NEED TO RESPOND TO CREDIT TIGHTENING (ON 21 JUNE) TO A DECISION TO REDUCE THE FED FUND'S RATE 3 WEEKS LATER.

15. IT IS POSSIBLE THAT THE CYNICAL SOLUTION MAY BE THE RIGHT ONE. PRESIDENT BUSH HAS CONCEDED AN IMPORTANT POINT OF PRINCIPLE BY AGREEING TO NEGOTIATE TAX INCREASES. HE MUST HAVE SOMETHING TO SHOW FOR IT. AT THE VERY LEAST, HE MUST AVOID A RECESSION. ENORMOUS PRESSURE HAS BEEN PUT ON THE FED TO REDUCE INTEREST RATES TO MINIMISE THIS RISK. GREENSPAN MAY SIMPLY FELT THAT THERE WAS SUFFICIENT JUSTIFICATION TO ALLOW HIM TO ACCEDE TO THIS PRESSURE.

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TREASURY FOR PS/CHANCELLOR, PERETZ, ALLAN, SEDGWICK
AND MELLISS. BANK FOR GREEN

US MONETARY POLICY: PROBABLE FED RATE REDUCTION

SUMMARY

1. FED CHAIRMAN GREENSPAN, IN TESTIMONY TO SENATE, REVEALS ACCUMULATING EVIDENCE OF CREDIT SQUEEZE. ANNOUNCES THAT FED MAY RESPOND BY REDUCING COST OF BANK FUNDS.

DETAIL

2. DURING AN APPEARANCE AT THE SENATE BANKING COMMITTEE TO TESTIFY ON DEPOSIT INSURANCE FED CHAIRMAN GREENSPAN WAS ASKED A GENERAL QUESTION TOUCHING ON THE ISSUE OF THE ALLEGED CONTRACTION IN CREDIT AVAILABILITY. GREENSPAN HAS GIVEN TESTIMONY ON THIS TOPIC ON NUMEROUS OCCASIONS OVER THE PAST TWO OR MORE MONTHS. ON EACH OCCASION HIS VIEW, LIKE THAT OF OTHER REGULATORS, HAS BEEN THAT THERE WAS NO GENERAL SHORTAGE OF CREDIT. SURVEY AND OTHER EVIDENCE POINTED TO PROBLEMS, BUT ONLY FOR LIMITED REGIONS (NOTABLY THE NORTHEAST) AND FOR SPECIFIC SECTORS (MERGERS AND ACQUISITIONS AND REAL ESTATE).

3. ON THIS OCCASION, HOWEVER, GREENSPAN NOTED THAT TWO FACTORS HAD RECENTLY GIVEN THE FED PAUSE FOR THOUGHT. FIRST, EVIDENCE NOW POINTED TO A RISE IN THE MARGIN BETWEEN THE COST OF BANK FUNDS AND LENDING RATES, AND TO A TIGHTENING OF COLLATERAL AND OTHER LENDING CONDITIONS. SECOND, M2 - THE MOST RELIABLE MONETARY AGGREGATE - HAD RECENTLY SHOWN SLOWER GROWTH THAN COULD BE FULLY EXPLAINED IN TERMS OF TECHNICAL FACTORS. INDEED, M2 CONTRACTED IN NOMINAL TERMS BETWEEN APRIL AND MAY.

4. THIS NEW EVIDENCE, COMBINED WITH EARLIER INDICATORS, WAS NOW INTERPRETED BY GREENSPAN AS SHOWING THAT QUOTE A MARKET TIGHTENING OF MODEST DIMENSIONS MAY BE OCCURRING UNQUOTE. GREENSPAN SAID THAT THE FED AT PRESENT DESIRED NEITHER TIGHTER NOR LOOSER MONETARY CONDITIONS. THEREFORE, IF THE FED CONCLUDED THAT CONDITIONS HAD TIGHTENED IT WOULD BE

APPROPRIATE TO RESPOND WITH A QUOTE VERY MODEST CHANGE IN THE LEVEL OF THE FEDERAL FUNDS RATE UNQUOTE. AN EARLY REDUCTION IN THE COST OF BANK FUNDS IS NOW WIDELY EXPECTED.

5. THERE WERE SEVERAL HIGHLY UNUSUAL ELEMENTS TO THIS STATEMENT. FED GOVERNORS ARE VERY CAREFUL NEVER TO REVEAL PROBABLE CHANGES IN MONETARY POLICY (GREENSPAN PARTICULARLY SO) YET THE ISSUE WAS APPARENTLY RAISED IN A PRE-MEDITATED FASHION. SEVERAL FACTORS PROBABLY ACCOUNT FOR THIS UNUSUAL DEVELOPMENT. FIRST, GREENSPAN MAY HAVE WANTED TO REASSURE FINANCIAL MARKETS AND CONGRESS. THE LATTER HAVE BEEN HIGHLY CONCERNED ABOUT THE RISK OF A SEVERE CREDIT CONTRACTION. HAD THE FED REDUCED RATES WITHOUT EXPLAINING THAT THE NEW EVIDENCE ON THE CREDIT CRUNCH WAS ONLY TENTATIVE, MARKETS MAY HAVE OVER-REACTED. SECOND, GREENSPAN MAY HAVE ALSO WANTED TO EMPHASISE THAT THIS WAS MERELY A ONE-OFF, TECHNICAL CORRECTION AND NOT THE FIRST OF A SERIES OF EASING STEPS. THIRD, THE FED ARE UNDER STRONG PRESSURE TO RESPOND TO, OR EVEN ANTICIPATE, A BUDGET AGREEMENT WITH A REDUCTION IN INTEREST RATES. BY FIRMLY IDENTIFYING THE LIKELY REDUCTION AS A RESPONSE TO CREDIT MARKET DEVELOPMENTS GREENSPAN HAS EMPHASISED THAT THE FED IS NOT BOWING TO ADMINISTRATION PRESSURES.

6. IT IS RATHER ODD THAT GREENSPAN USED THIS OCCASION TO DISCUSS THE PROBABILITY OF A RATE REDUCTION RATHER THAN WAITING UNTIL HIS BI-ANNUAL APPRAISAL OF MONETARY POLICY AND ECONOMIC PROSPECTS BEFORE THE SAME COMMITTEE SCHEDULED FOR 18 JULY. ONE CAN ONLY CONCLUDE THAT THE FED EXPECT TO REDUCE RATES PRIOR TO THIS DATE AND DECIDED TO EXPLAIN THE ACTION NOW.

7. MARKET REACTIONS HAVE, AS YET, BEEN MODEST. AROUND MIDDAY, THE DOW INDUSTRIAL SHARE PRICE AVERAGE WAS UP, BUT ONLY FRACTIONALLY, AND THE DOLLAR HAD FALLEN ONE PER CENT. COMMENT

8. FOLLOWING GREENSPAN'S COMMENTS IT WILL BE VERY DIFFICULT NOT TO REDUCE THE FEDERAL FUNDS RATE. THE FED HOPE THAT THIS WILL HAVE NO MAJOR SIGNIFICANCE FOR THE WIDER ECONOMY: THEY ARE ATTEMPTING TO LEAVE MONETARY CONDITIONS BROADLY UNCHANGED. BY SUCH PRE-EMPTIVE ACTION THEY MAY BE SUCCESSFUL IN AVOIDING A CREDIT-INDUCED DOWNTURN. INDEED, GREENSPAN STRESSED THAT THE FED STILL FIRMLY DISCOUNTED THE RISKS OF A RECESSION. HOWEVER, IT NOW LOOKS AS IF THE FED HAS A MORE DIFFICULT HAND TO PLAY THAN PREVIOUSLY BELIEVED.

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PRESIDENT BUSH'S U-TURN ON QUOTE NO NEW TAXES UNQUOTE
SUMMARY

1. BUSH ANNOUNCES THAT HE ACCEPTS THAT QUOTE TAX REVENUE INCREASES UNQUOTE SHOULD BE PART OF A BUDGET DEFICIT REDUCTION PACKAGE, THUS MAKING EXPLICIT THE U-TURN ON QUOTE NO NEW TAXES UNQUOTE IMPLIED WHEN HE SAID THAT EVERYTHING WAS ON THE TABLE IN THE CURRENT BUDGET TALKS WITH CONGRESS.

2. DECISION UNBLOCKS THE DEFICIT REDUCTION TALKS, BUT MANY DIFFICULT ISSUES REMAIN TO BE RESOLVED. POLITICAL DAMAGE TO BUSH IS LIKELY TO BE LESS THAN MANY DEMOCRATS HOPED, OR REPUBLICANS FEARED, MAINLY BECAUSE BUSH'S PLEDGE HAD ALREADY BEEN WIDELY DISCOUNTED BY POLITICIANS AND PUBLIC ALIKE.

DETAIL

3. YOU MAY LIKE SOME FIRST IMPRESSIONS OF THE POLITICAL AND ECONOMIC FALL-OUT FROM PRESIDENT BUSH'S ANNOUNCEMENT ON 26 JUNE THAT HE ACCEPTED THAT QUOTE TAX REVENUE INCREASES UNQUOTE SHOULD BE PART OF A DEFICIT REDUCTION PACKAGE.
4. WE ARE SENDING THE FULL TEXT OF THE WHITE HOUSE STATEMENT BY FAX TO NAD, BUT THE OPERATIVE SECTION READS AS FOLLOWS:
QUOTE IT IS CLEAR TO ME THAT BOTH THE SIZE OF THE DEFICIT PROBLEM AND THE NEED FOR A PACKAGE THAT CAN BE ENACTED REQUIRE ALL OF THE FOLLOWING: ENTITLEMENT AND MANDATORY PROGRAM REFORM, TAX REVENUE INCREASES, GROWTH INCENTIVES, DISCRETIONARY SPENDING REDUCTIONS, ORDERLY REDUCTIONS IN DEFENSE EXPENDITURES AND BUDGET PROCESS REFORM UNQUOTE
5. ON WHAT WAS AN EXCEPTIONALLY BUSY POLITICAL DAY IN WASHINGTON (MANDELA WAS ADDRESSING A JOINT SESSION OF CONGRESS, AND THE ADMINISTRATION ANNOUNCED TWO MAJOR ENVIRONMENTAL DECISIONS), THE STATEMENT WAS ISSUED FOLLOWING A BREAKFAST WHICH THE PRESIDENT HAD HAD WITH THE BIPARTISAN CONGRESSIONAL LEADERSHIP. THE PRESIDENT REFUSED THROUGHOUT THE DAY TO TAKE QUESTIONS ON THE

STATEMENT, (AND THE WHITE HOUSE SPOKESMAN STONE-WALLED) WHICH IS WIDELY BELIEVED TO HAVE BEEN THE RESULT OF INSISTENCE BY THE DEMOCRATIC BUDGET NEGOTIATORS, IN INTENSIVE TALKS OVER THE PAST FEW DAYS, THAT THE TALKS COULD GO NO FURTHER UNTIL THE PRESIDENT EXPLICITLY ACKNOWLEDGED THAT TAX INCREASES WOULD HAVE TO BE PART OF ANY BIPARTISAN AGREEMENT TO CUT THE BUDGET DEFICIT.

6. THE PRESIDENT IS LIKELY THEREFORE TO HAVE CALCULATED THAT THE NET POLITICAL DAMAGE FROM SUCH AN ACKNOWLEDGEMENT WAS LIKELY TO BE LESS THAN THE RISK THAT AN IMPASSE IN THE DEFICIT REDUCTION TALKS WOULD ADVERSELY EFFECT THE ECONOMY, AND THUS THE REPUBLICANS' CHANCES IN THE 1990 AND 1992 ELECTIONS.

7. IT IS TOO EARLY TO SAY HOW BUSH'S CHANGE OF POLICY WILL BE RECEIVED IN THE COUNTRY AS A WHOLE. BUT IN WASHINGTON THE STORM HAS BEEN LESS SEVERE THAN MANY EXPECTED, PARTLY BECAUSE THE WHITE HOUSE APPEARS SUCCESSFULLY TO HAVE PERSUADED THE DEMOCRATIC LEADERSHIP NOT TO CROW, AND BECAUSE SOME OF THE KEY POTENTIAL REPUBLICAN CRITICS OF THE ANNOUNCEMENT HAD BEEN NEUTRALISED IN ADVANCE BY THE WHITE HOUSE, WHO HAVE ALSO BEEN EXERCISING A GOOD DEAL OF QUOTE SPIN CONTROL UNQUOTE. THE MAIN FACTOR, HOWEVER, IN MINIMISING POLITICAL DAMAGE TO THE PRESIDENT HAS BEEN THAT BUSH'S PLEDGE OF QUOTE NO NEW TAXES UNQUOTE HAD ALREADY BEEN HEAVILY DISCOUNTED IN THE POLITICAL STOCK MARKET: POLLS SHOW THAT, EVEN AT THE TIME THE PLEDGE WAS ORIGINALLY GIVEN (AT THE REPUBLICAN CONVENTION IN AUGUST 1988), OVER TWO THIRDS OF VOTERS DID NOT BELIEVE THAT BUSH WOULD BE ABLE TO HONOUR IT. AND VOTERS' CYNLCISM ABOUT THE PLEDGE WAS REINFORCED BY BUSH'S DECISION, IN INITIATING THE BUDGET TALKS, TO PUT EVERYTHING ON THE TABLE (MY TELNO 1094 (NOT TO ALL)).

8. THAT HAS NOT, HOWEVER, PREVENTED PREDICTABLE CRIES OF ANGUISH FROM THE RIGHT WING, AND FROM REPUBLICAN INCUMBENTS AND CANDIDATES FACING CLOSE RACES IN NOVEMBER. ALL THREE OF THE PARTY'S BEST PROSPECTS FOR CAPTURING DEMOCRATIC SENATE SEATS (IN ILLINOIS, IOWA AND RHODE ISLAND) ISSUED STATEMENTS ON 26 JUNE URGING THE PRESIDENT NOT TO RAISE TAXES: AND A SIMILAR LETTER CIRCULATING AMONG CONSERVATIVE REPUBLICANS IN THE HOUSE RECEIVED OVER 60 SIGNATURES. SOME MORE INGENIOUS CONSERVATIVES HAVE ARGUED, BUT WITHOUT MUCH CONVICTION, THAT ECONOMIC GROWTH WILL PRODUCE THE QUOTE TAX REVENUE INCREASES UNQUOTE WITHOUT ANY INCREASES IN TAXES.

9. BOTH SIDES IN THE DEFICIT REDUCTION TALKS HAVE SAID THAT THE ANNOUNCEMENT CLEARS THE WAY FOR A BUDGET DEAL BEFORE THE AUGUST RECESS. BUT WIDE GAPS REMAIN BETWEEN THE TWO SIDES, NOT ONLY ON WHAT KIND OF TAX INCREASES WOULD BE ACCEPTABLE (INCREASED INCOME TAX, ESPECIALLY ON THE WEALTHIEST AMERICANS, OR INDIRECT

TAXATION, PARTICULARLY SIN TAXES), BUT ALSO ON THE AREAS WHERE EXPENDITURE CUTS WILL BE NEEDED. A GREAT DEAL OF POLITICAL WRANGLING AND OBFUSCATION THUS LIES AHEAD, AND IT IS BY NO MEANS CERTAIN THAT A DEAL WILL BE CUT BEFORE THE END OF THE FISCAL YEAR ON 30 SEPTEMBER.

10. BUSH'S ANNOUNCEMENT ON 26 JUNE IS THUS A NECESSARY, BUT FAR FROM SUFFICIENT, CONDITION FOR A SUCCESSFUL OUTCOME TO THE DEFICIT REDUCTION TALKS: AND, WHEREAS BUSH SEEMS LIKELY TO SUFFER LESS POLITICAL DAMAGE THAN EXPECTED FOR WHAT IS BY ANY MEASURE A RADICAL CHANGE OF COURSE, EQUALLY HE SEEMS LIKELY TO BE GIVEN LITTLE POLITICAL CREDIT FOR AT LAST ADJUSTING A POLICY WHICH MANY BELIEVED WAS LITTLE MORE THAN A CYNICAL ELECTION-WINNING GAMBIT.

11. FURTHER COMMENT ON THE ECONOMIC IMPLICATIONS FOLLOWS.

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THE SAVINGS AND LOANS (THRIFTS) CRISIS

SUMMARY

1. THRIFTS COLLAPSE CAUSED BY WEAK FEDERAL SUPERVISION, MISMANAGEMENT, FRAUD, AND A COLLAPSE IN PROPERTY PRICES. BUSH ADMINISTRATION HAS ESTABLISHED MACHINERY TO DEAL WITH THE MESS, BUT FORECAST COSTS ARE ESCALATING AND EXACERBATING THE BUDGET DEFICIT. BOTH THE ADMINISTRATION AND CONGRESS ARE VULNERABLE TO ACCUSATIONS OF RESPONSIBILITY FOR THE THRIFT COLLAPSE AS THE PUBLIC BECOMES MORE AWARE OF THE SCALE OF THE PROBLEM. BUT, THE ABSENCE OF ANY DIRECT PAIN ON PRESENT VOTERS MAY LIMIT THE POLITICAL IMPACT.

DETAIL

2. FOR MANY YEARS UP TO 1980, SAVINGS AND LOANS ASSOCIATIONS (THRIFTS, EQUIVALENT TO BRITISH BUILDING SOCIETIES) WERE TIGHTLY CONTROLLED. INTEREST PAID ON DEPOSITS AND CHARGED FOR (USUALLY) FIXED RATE MORTGAGES WERE SET BY THE GOVERNMENT, WHICH ALSO INSURED THE DEPOSITS. HIGH MARKET INTEREST RATES IN THE LATE 1970S FORCED THRIFTS TO INCREASE RATES FOR DEPOSITS. BUT, SINCE MOST OF THEIR ASSETS WERE STILL IN LOW, FIXED RATE, MORTGAGES, MANY BECAME INSOLVENT. RATHER THAN INCUR THE COSTS OF CLOSING THEM DOWN, THE THRIFT REGULATORS GAMBLER THAT A FUTURE REDUCTION OF INTEREST RATES WOULD RESTORE SOLVENCY TO MOST THRIFTS. THEY THEREFORE LET THEM CONTINUE TRADING WITH LITTLE OR NO CAPITAL. IN 1982, CONGRESS PASSED LEGISLATION ALLOWING THRIFTS TO DIVERSIFY THEIR INVESTMENTS BEYOND HOME MORTGAGES, AND INCREASED DEPOSIT INSURANCE TO GIVE 100 PER CENT BACKING TO ALL DEPOSITS UNDER DOLLARS 100,000

3. THIS COMBINATION PROVED LETHAL. THRIFT OWNERS (MANY OF WHOM HAD ACQUIRED INSOLVENT INSTITUTIONS VERY CHEAPLY) HAD VIRTUALLY NO CAPITAL OF THEIR OWN AT RISK. WITH EXTENSIVE DEPOSIT INSURANCE THEY COULD BID FOR AS MANY DEPOSITS AS THEY LIKED (BROKERS PROVIDED DEPOSITS BROKEN DOWN INTO DOLLAR 100,000 BLOCKS) AND GAMBLE ON COMMERCIAL PROPERTY, JUNK BONDS OR OTHER HIGH RISK HIGH YIELD VENTURES. IF THE GAMBLE PAID OFF, THE BENEFIT WENT TO THE THRIFT OWNERS. IF IT FAILED, THE GOVERNMENT

PAID OFF THE DEPOSITORS.

4. ALTHOUGH, INITIALLY, BOOMING PROPERTY MARKETS PROVIDED HUGE PROFITS AND ALLOWED MASSIVE EXPANSION OF SOME THRIFTS, THE GAMBLERES MOSTLY FAILED. EXTRAVAGANT LIVING AND BAD INVESTMENTS BY MANY THRIFT OWNERS WEAKENED THRIFTS WHICH COULD NOT WITHSTAND THE EFFECTS OF THE OIL PRICE FALL ON THE PROPERTY MARKET, PARTICULARLY IN THE SOUTH WEST. WEAK REGULATORS, ENCOURAGED BY CONGRESSMEN WITH LARGE CAMPAIGN CONTRIBUTIONS FROM THRIFT OWNERS, ALLOWED TOO MANY INSOLVENT THRIFTS TO STRUGGLE ON. THE EVENTUAL CRASH WAS ALL THE GREATER. WHEN IT CAME, THE DEPOSIT INSURANCE FUND COULD NOT MEET ALL ITS POTENTIAL CLAIMS. THE GOVERNMENT HAD TO STEP IN.

5. IN 1989, PRESIDENT BUSH INITIATED LEGISLATION TO PROVIDE FUNDS TO PAY THE INSURED DEPOSITORS, REFORM THE REGULATORY PROCESS, IMPOSE HIGHER CAPITAL STANDARDS ON THRIFTS, AND CREATE THE RESOLUTION TRUST CORPORATION (RTC) TO DEAL WITH FAILED THRIFTS. THE RTC HAS TO TAKE OVER THE ASSETS OF FAILED THRIFTS, SELL THEM, AND PAY OFF DEPOSITORS USING TAXPAYER MONEY TO FILL THE GAP BETWEEN ASSETS AND LIABILITIES.

6. AT PRESENT, OF THE 2500 THRIFTS, 38 PER CENT, ACCOUNTING FOR 61 PER CENT OF THE ASSETS, DO NOT MEET THE CAPITAL STANDARDS OF THE NEW LEGISLATION. THE RTC IS WORKING ITS WAY THROUGH INSOLVENT THRIFTS. SOME OF THOSE CURRENTLY SOLVENT BUT BELOW THE LEGAL CAPITAL STANDARDS WILL FALL INTO THE RTC'S HANDS. OTHERS WILL ACHIEVE THE CAPITAL STANDARDS BY RAISING EQUITY OR BY MERGING. THE INDUSTRY WILL UNDOUBTEDLY SHRINK. IN THE NOT VERY LONG TERM, IT MAY DISAPPEAR, SINCE THE US PROBABLY DOES NOT NEED A SPECIALIST HOUSING FINANCE INDUSTRY. SURVIVING THRIFTS MAY BECOME BANKS.

7. THE THRIFTS CRISIS HAS CLEARLY AFFECTED THE US BUDGET. THE ADMINISTRATION'S FIRST (FEBRUARY 1989) ESTIMATE OF THE EVENTUAL (10 YEAR) NET COST WAS DOLLARS 115 BN. AN INCREASE IN THE FORECAST OF FAILING THRIFTS AND A DECREASE IN THE FORECAST OF RECEIPTS FROM ASSETS HAS INCREASED THAT ESTIMATE (JUNE 1990) TO DOLLARS 205 BN.

8. BUT EXPENDITURE ON REPAYING DEPOSITORS PREDATES RECEIPTS FROM ASSET SALES. THE RTC NOW HAS A LARGER ASSET BASE THAN CITIBANK DUMPING. THESE ASSETS ON THE DEPRESSED PROPERTY MARKET COULD PUT PRICES THROUGH THE FLOOR, WEAKENING OTHER THRIFTS AND BANKS. THE RTC IS HOLDING ON TO ASSETS LONGER THAN EXPECTED, DELAYING RECEIPTS AND INCREASING SHORT-TERM FINANCING NEEDS. IT IS NOW ESTIMATED THAT UP TO DOLLARS 48 BN WILL BE NEEDED IN THE PRESENT FINANCIAL YEAR (FY90) AND UP TO DOLLARS 68 BN IN FY91. ON THE BASIS OF THEIR RANGE OF FORECASTS FOR RTC EXPENDITURE,

THE ADMINISTRATION NOW FORECAST THE DEFICIT AS FOLLOWS:

	FY90	FY91
THRIFTS	26-48	41-68
DEFICIT EXCLUDING THRIFTS	158	159
TOTAL BUDGET DEFICIT	184-206	200-227
TARGET	100	64

UNDER THE GRAMM RUDMAN LAW, IF THE DEFICIT TARGET FOR FY91 WERE MISSED BY AS MUCH AS THESE FIGURES SUGGEST, AUTOMATIC SPENDING CUTS WOULD REDUCE DEFENCE BY 30 PER CENT, AND WIPE OUT MANY DOMESTIC PROGRAMMES. SUCH CARNAGE IS UNACCEPTABLE. THE ADMINISTRATION AND CONGRESSIONAL LEADERS ARE LOOKING FOR A WAY OUT. AGREEMENT WILL BE SOME TIME IN COMING, BUT WILL ALMOST CERTAINLY RESULT IN THE EXEMPTION OF THRIFT SPENDING FROM THE DEFICIT CALCULATIONS. SOME DEFICIT REDUCTION MEASURES, AND A CHANGE IN THE TARGETS SO THAT THEY ARE EASIER TO HIT.

9. HITHERTO THERE HAS BEEN LITTLE ATTEMPT TO EXPLOIT THE THRIFTS MESS FOR POLITICAL ADVANTAGE. THE REAGAN ADMINISTRATION PRESIDED OVER THE COLLAPSE, BUT THAT COLLAPSE WAS EXACERBATED BY THE WILLINGNESS OF CONGRESSMEN TO RESPOND TO THE WELL FINANCED THRIFT LOBBY AND TO PRESS REGULATORS TO LAY OFF FAILING THRIFTS. SEVERAL CONGRESSMEN (INCLUDING FORMER SPEAKER WRIGHT AND FORMER HOUSE BANKING COMMITTEE CHAIRMAN ST. GERMAINE) LOST THEIR SEATS THROUGH THEIR ASSOCIATION WITH DUBIOUS THRIFT OWNERS, AND FIVE SENATORS (BOTH DEMOCRATS AND REPUBLICANS) ARE UNDER INVESTIGATION FOR POSSIBLY EXERTING IMPROPER INFLUENCE TO SAVE A FAILING THRIFT. THE INVOLVEMENT OF ONE OF BUSH'S OWN SONS IN A FAILED THRIFT HAS BEEN PLAYED RELATIVELY LOW-KEY.

10. VERY RECENTLY, HOWEVER, DEMOCRATS HAVE STARTED TO ACCUSE BUSH OF BUNGLING THE THRIFT CLEAN-UP, ARGUING THAT THE RTC IS MOVING TOO SLOWLY, THUS INCREASING THE COST, AND THAT NOT ENOUGH IS BEING DONE TO PROSECUTE FRAUD. THEY ARE ALSO MAKING THE MORE GENERAL POINT (EMERGING AS A NEW POLITICAL THEME HERE) THAT THE REAGAN/BUSH ADMINISTRATION REPRESENTED A BONAZA FOR THE RICH, WHEREAS THE ORDINARY MAN IN THE STREET IS TAKING THE CONSEQUENCES. BUSH HAS RESPONDED SHARPLY, THREATENING TO DRAW ATTENTION TO CONGRESS'S PART IN THE COLLAPSE, WHILE AT THE SAME TIME ALLOCATING INCREASED FUNDS TO THE PROSECUTION EFFORT, WHICH HE HAS SAID WILL BE INTENSIFIED.

11. THE THRIFT COLLAPSE IS NOT CAUSING VOTERS DIRECT PAIN. BY BORROWING TO PAY OFF DEPOSITORS, THE GOVERNMENT IS ENSURING THAT THE ECONOMIC LOSS CAUSED BY THE COLLAPSE IS PAID FOR BY PRESENT AND (MOSTLY) FUTURE TAXPAYERS. INCREASING THE DOLLARS 3

TRILLION PUBLIC DEBT BY DOLLARS 200 BN WILL NOT MATERIALLY AFFECT TAXES PAID BY EXISTING TAXPAYERS. MOREOVER, ALTHOUGH THE COST OF THE COLLAPSE IS MIND-BOGGLING, AMERICANS ARE USED TO HEARING SCARE STORIES IN BILLIONS OF DOLLARS (THE BUDGET AND TRADE DEFICITS, THE NUCLEAR PLAN CLEAN UP, AND SO ON).

12. ON THE OTHER HAND, THE EXTENT OF FRAUD IS STIMULATING SOME MORAL OUTRAGE, AND IT MAY BE THAT ANY INCREASE IN TAXATION WHICH EMERGES FROM THE CURRENT BUDGET NEGOTIATION WILL BE SEEN (WRONGLY) AS THE COST OF THE THRIFTS. THE EVIDENCE OF RECENT DAYS SHOWS THAT BOTH DEMOCRATS AND BUSH BELIEVE THERE IS THE POTENTIAL FOR A VOTER BACKLASH.

13. MORE LIKELY, PERHAPS, IS THAT THE NON-AGGRESSION PACT WHICH MAY EMERGE FROM THE BUDGET NEGOTIATIONS (BOTH SIDES WILL AGREE TO SUPPORT THE DEAL AND NOT DRAW ATTENTION TO THE OTHER'S CONCESSIONS) WILL EXTEND TO THE THRIFTS. BUSH AND CONGRESSIONAL LEADERS RECOGNISE THAT BOTH SIDES ARE VULNERABLE. AT THE SAME TIME, WITH AN ELECTION IN NOVEMBER, IT IS INEVITABLE THAT SOME CONGRESSMEN AND THEIR CHALLENGERS (WHERE THEY DO NOT THEMSELVES FEEL VULNERABLE WILL EXPLOIT THE ISSUE. OVERALL, BUSH DESERVES TO RIDE OUT THE STORM. HE HAS PUT THE NECESSARY MACHINERY IN PLACE TO RESOLVE THE ISSUE, AND ALTHOUGH NOT PERFECT, HIS REFORM WAS PROBABLY THE BEST POSSIBLE PACKAGE.

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US TRADE POLICY AND THE URUGUAY ROUND

SUMMARY

1. THE US ENTERS THE FINAL SIX MONTHS OF THE URUGUAY ROUND WITH ITS FREE TRADE CREDENTIALS IN REASONABLE ORDER AND A SUCCESSFUL CONCLUSION THE QUOTE TOP TRADE LIBERALISING PRIORITY UNQUOTE. THE ADMINISTRATION WILL USE THIS MONTH'S OECD MINISTERIAL AND THE HOUSTON SUMMIT TO ADVANCE ITS MAIN GOALS IN THE ROUND: THE OPENING OF OVERSEAS MARKETS TO US AGRICULTURE, INVESTMENT AND SERVICE INDUSTRIES AND THE PROTECTION OF US INTELLECTUAL PROPERTY.

2. THE ROUND WILL INCREASINGLY BECOME AN ISSUE OF DOMESTIC POLITICS. APPROVAL OF THE FINAL PACKAGE WILL DEPEND ALMOST AS MUCH ON THE CONGRESSIONAL PROCESS AS ON SUBSTANCE. THIS IS NOT NECESSARILY GOOD NEWS FOR THE GATT.

DETAIL

3. TRADE POLICY HAS SO FAR BEEN A SUCCESS FOR BUSH AND MRS HILLS, THE US TRADE REPRESENTATIVE AND NEGOTIATOR-IN-CHIEF. THEY HAVE MANAGED TO PLACATE ALL BUT THE WILD MEN IN CONGRESS AND HAVE DONE SO WITHOUT INFLICTING TOO MUCH DAMAGE ON US CREDIBILITY IN THE URUGUAY ROUND OR SETTING OFF OPEN WARFARE WITH MAJOR TRADING PARTNERS.

4. THE FREE-TRADING, FREE MARKET INSTINCTS OF THE BUSH ADMINISTRATION ARE CONSTRAINED POLITICALLY BY A CONGRESS PERENNIALY ATTRACTED TO ECONOMIC NATIONALISM, AND LEGALLY BY THE 1988 TRADE ACT. THE LATTER REQUIRES THE ADMINISTRATION PUBLICLY TO IDENTIFY ALLEGEDLY UNFAIR TRADING PARTNERS: TO TRY TO NEGOTIATE AWAY THE OFFENDING PRACTICES: AND, FAILING THAT, TO RETALIATE. SUPER 301 IS ONLY THE BEST KNOWN OF VARIOUS PROVISIONS OF THIS KIND IN THE ACT. THE TRADE ACT HAD THE POTENTIAL TO BECOME AN INSTRUMENT OF AGGRESSIVE MERCANTILISM. IN THE EVENT HOWEVER - THOUGH THIS DOES NOT REMOVE THE OBJECTIONS OF PRINCIPLE TO UNILATERALISM - MRS HILLS HAS USED 301 WITH SOME SKILL AND

RESTRAINT. WITH THE SIX SUPER 301 CASES IN 1989, THE ADMINISTRATION ESTABLISHED ITS BONA FIDES WITH CONGRESS AND SPURRED NEGOTIATIONS, NOTABLY WITH JAPAN. THIS YEAR THERE WERE NO NEW SUPER 301 CASES, AND MRS HILLS HAS FOLDED MOST BILATERAL TRADE DISPUTES INTO MULTILATERAL NEGOTIATIONS, INCLUDING THE URUGUAY ROUND ITSELF.

5. THE ADMINISTRATION HAS THEREFORE SUCCESSFULLY CLEARED THE DECKS FOR ITS NEGOTIATORS IN GENEVA AS THE END-GAME BEGINS. THE STORY WOULD HAVE BEEN DIFFERENT HAD ANY OF A NUMBER OF TRADE DISPUTES WITH JAPAN NOT BEEN SETTLED LAST MONTH, AT LEAST FOR THE TIME BEING. AS MUCH AS ANYTHING, JAPANOPHOBIA - RIFE IN CONGRESS AND SOME PARTS OF THE BUSINESS COMMUNITY - HAS THE CAPACITY TO OVERTURN THE ADMINISTRATION'S BETTER INSTINCTS IN TRADE POLICY. THANKS TO THE SUCCESS OF LAST MONTH'S HERCULEAN NEGOTIATING EFFORT, FOLLOWING THE INTERVENTION OF BUSH AND KAIFU, JAPANOPHOBIA IS IN REMISSION AT LEAST FOR THE TIME BEING. BUT IF THE JAPANESE SLIDE AWAY FROM THEIR COMMITMENTS, OR THE BILATERAL TRADE DEFICIT BEGINS AGAIN TO WIDEN, THIS WILL REACTIVATE THE DISEASE.

6. WHEN THE PRESIDENT RAISED WITH THE PRIME MINISTER AT BERMUDA THE QUESTION OF AGRICULTURE IN THE URUGUAY ROUND, THIS SIGNALLED THE START OF A HIGH-LEVEL POLITICAL CAMPAIGN IN SUPPORT OF THE MAIN US OBJECTIVES: THE OPENING OF OVERSEAS MARKETS TO US FARMERS, INVESTORS AND SERVICE INDUSTRIES AND THE PROTECTION ABROAD OF US INTELLECTUAL PROPERTY. WE CAN EXPECT THE AMERICANS TO MAKE SIMILAR USE OF THIS MONTH'S OECD MINISTERIAL AND THE HOUSTON SUMMIT. HAVING THUS STAKED SO MUCH, SO PUBLICLY ON THE OUTCOME, MRS HILLS IS NOW NERVOUS AT THE SLOW PACE, AS SHE SEES IT, OF NEGOTIATIONS. BUT SHE HAS A DOUBLE PROBLEM: TO BRING BACK A GOOD PACKAGE: AND TO SELL IT TO CONGRESS. THE 1988 TRADE ACT REQUIRES THE PACKAGE TO BE SUBMITTED ON THE HILL BY 1 MARCH 1991. UNDER THE SO-CALLED FAST TRACK AUTHORITY, CONGRESS CANNOT PICK AND CHOOSE FROM THE URUGUAY ROUND MENU, BUT MUST VOTE FOR OR AGAINST THE PACKAGE AS A WHOLE. FAILURE TO MEET THE TRADE ACT DEADLINES WILL CAUSE THE FAST TRACK AUTHORITY TO LAPSE AND ALLOW CONGRESS TO PICK APART ANY PACKAGE LINE BY LINE (ALTERNATIVELY, IT IS OPEN TO THE PRESIDENT TO SEEK A TWO-YEAR EXTENSION OF THIS AUTHORITY - BUT THAT WOULD BE AT THE COST OF ANOTHER TRADE ACT AND WOULD PROBABLY BE THE END ALSO FOR THE ROUND).

7. HANDLING CONGRESS AND THE SPECIAL INTERESTS REPRESENTED ON THE HILL WILL BE AN INCREASING PREOCCUPATION FOR THE ADMINISTRATION. DOMESTIC POLITICAL PRESSURES ARE STARTING TO BUILD. LAST MONTH THE HOUSE WAYS AND MEANS COMMITTEE - WHO, WITH THE SENATE FINANCE COMMITTEE, WILL BE CENTRAL TO

CONGRESSIONAL APPROVAL OR OTHERWISE OF THE ROUND'S OUTCOME - TAUGHT THEMSELVES IN ON THE URUGUAY ROUND AT A WEEKEND RETREAT. THE MAIN LOBBIES, WHO ARE INCREASINGLY POSITIONING THEMSELVES IN PUBLIC ON WHAT THEY WANT FROM THE ROUND, WERE ALSO PRESENT. MEANWHILE, NEW PRIVATE SECTOR COALITIONS ARE BEING FORMED, BOTH FOR AND AGAINST THE ROUND.

8. THE KEY TO GETTING CONGRESS ON BOARD WILL BE TO BRING BACK A PACKAGE FROM WHICH THE WINNERS IN THE PRIVATE SECTOR CARRY MORE CONGRESSIONAL CLOUT THAN THE LOSERS. THE BETTING IS THAT AN OUTCOME WHICH, SAY, KEEPS THE SERVICE INDUSTRIES (WITH STAKES IN A RANGE OF ROUND NEGOTIATIONS, EG TRIMS, TRIPS, AS WELL AS SERVICES THEMSELVES) AND GRAIN EXPORTERS HAPPY AT THE EXPENSE OF THE TEXTILES INDUSTRY AND OTHER FARMING SECTORS (DAIRY, PEANUTS) WILL DO THE TRICK. DESPITE CURRENT US HESITATION ABOUT WHICH WAY TO JUMP ON TEXTILES, REFLECTING IN PART THE EFFORTS OF AN INFLUENTIAL PROTECTIONIST LOBBY, AN OUTCOME ON THESE LINES WOULD BROADLY REFLECT US STRATEGIC OBJECTIVES FOR THE ROUND.

9. THE URUGUAY ROUND END-GAME WILL TEST THE ADMINISTRATION'S COMMITMENT TO THE MULTILATERAL TRADING SYSTEM, BUT PARTICULARLY SO IF THE ADVANTAGES AND DISADVANTAGES FOR AMERICAN INTERESTS ARE NOT CLEAR-CUT. BUSH HAS A GOOD TRADE POLICY RECORD SO FAR. BUT THERE MUST ALWAYS BE DOUBTS ABOUT AN ADMINISTRATION AS SENSITIVE AS HIS TO THE POLLS AND CONGRESSIONAL OPINION. THE ROUND WILL BE COMING TO A CLIMAX WITH THE MID-TERM ELECTION CAMPAIGNS IN NOVEMBER. PEOPLE ARE AWARE THAT IN THE 1988 PRESIDENTIAL CAMPAIGNS, ECONOMIC NATIONALISM HAD ITS ELECTORAL APPEAL. THERE ARE ALSO, AT THIS RANGE, IMPONDERABLES WHICH WILL AFFECT PUBLIC AND CONGRESSIONAL SENTIMENT FOR BETTER OR WORSE, DEPENDING ON HOW THE NUMBERS COME OUT: THE STATE OF THE ECONOMY, THE TRADE DEFICIT, THE BUDGET DEFICIT AND SO ON.

10. MRS HILLS IS THEREFORE PLAYING FOR HIGH STAKES IN A GAME OVER WHICH, THANKS TO THE POWERS INVESTED IN CONGRESS BY THE CONSTITUTION, SHE HAS TO SHARE CONTROL. AS ONE COMMENTATOR RECENTLY PUT IT, IN THE US THE URUGUAY ROUND OUTCOME WILL BE JUDGED NOT BY THE ECONOMICS OF TRADE IN GENEVA, BUT BY THE POLITICS OF TRADE IN WASHINGTON.

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UNITED STATES MONTHLY ECONOMIC REPORT: MARCH 1990 SUMMARY

SUMMARY

1. US ECONOMIC ACTIVITY TICKING OVER, WITH FIRST QUARTER GROWTH PROBABLY ONLY marginally STRONGER THAN 1 PER CENT FOURTH QUARTER RATE. INDUSTRIAL ACTIVITY FLAT, BUT WARM SPRING BUOYS CONSTRUCTION SECTOR. NO CHANGE IN INTEREST RATES AFTER LATEST FED MONETARY POLICY REVIEW. FINANCIAL MARKET ATTENTION FOCUSES ON SOARING RATE OF DOLLAR AGAINST YEN.

ACTIVITY AND INFLATION

2. FOURTH QUARTER GNP GROWTH HAS BEEN REVISED UP marginally FROM A 0.9 TO 1.1 PER CENT RATE OF EXPANSION. FIRST QUARTER GROWTH IS ALSO LIKELY TO HAVE BEEN SLUGGISH: CONSUMER SPENDING PROVED BUOYANT, BUT APPEARS TO HAVE BEEN SUPPLIED IN LARGE PART OUT OF EXISTING STOCKS RATHER THAN NEW PRODUCTION. OTHER AREAS OF DOMESTIC DEMAND SUCH AS BUSINESS AND HOUSING INVESTMENT ARE IN THE DOLDRUMS. NET EXPORTS MAY SUPPLEMENT GROWTH, BUT THE TRADE FIGURES (SEE BELOW) SHOW LITTLE CHANGE IN THE DEFICIT OVER RECENT MONTHS.

3. ACTIVITY REMAINS WEAKEST IN THE INDUSTRIAL SECTOR. IN FEBRUARY, RESUMED ACTIVITY AT US CAR PLANTS, WHICH WERE SHUT

DOWN IN JANUARY TO DEplete BLOATED STOCKS, CONTRIBUTED TO A HALF PER CENT RISE IN INDUSTRIAL PRODUCTION AND A 2 PER CENT RISE IN MANUFACTURERS' NEW ORDERS. EXCLUDING THIS AND OTHER DISTORTIONS, INDUSTRIAL ACTIVITY HAS BEEN FLAT FOR ALMOST A YEAR, THOUGH SURVEY EVIDENCE SUGGESTS THAT CONDITIONS MAY NOW BE MARGINALLY LESS DOWNBEAT THAN SIX MONTHS AGO.

4. CONSTRUCTION SECTOR ACTIVITY, BY CONTRAST, BENEFITTED FROM A Milder THAN USUAL JANUARY AND FEBRUARY. (FAVOURABLE WEATHER MAY ALSO EXPLAIN THE STRONG GROWTH OF SERVICE SECTOR EMPLOYMENT IN THESE TWO MONTHS.) BECAUSE JOBS WERE BROUGHT FORWARD INTO JANUARY AND FEBRUARY FROM MARCH, THE LATTER SHOWED THE LOWEST (SEASONALLY ADJUSTED) MONTHLY EMPLOYMENT INCREASE FOR ALMOST FOUR YEARS. TAKING THE FIRST QUARTER AS A WHOLE, JOB GAINS WERE COMPARABLE TO EXPERIENCE IN 1989. THE RATE OF UNEMPLOYMENT IN MARCH, AT 5.2 PER CENT, WAS UNCHANGED FROM THE 1989 AVERAGE.

5. HAVING RISEN SHARPLY IN JANUARY ON ACCOUNT OF WEATHER-INDUCED INCREASES IN FOOD AND ENERGY COSTS, PRODUCER PRICES WERE UNCHANGED IN FEBRUARY WHILE CONSUMER PRICES ROSE 0.4 PER CENT. THE LATTER FIGURE WAS STRONGER THAN EXPECTED, PERHAPS REFLECTING AN EARLIER THAN USUAL INTRODUCTION OF SPRING CLOTHING PRICE INCREASES. ON BALANCE, THE UNDERLYING (IE EXCLUDING FOOD AND ENERGY) INFLATION FIGURES ARE NOT TOO DISTURBING: THE CPI MEASURE IS FLAT, WHILE THE PRODUCER PRICE MEASURE IS TRENDING DOWNWARDS. HOWEVER, THIS ACKNOWLEDGED, THE HEADLINE ANNUAL INFLATION FIGURES ARE BACK ABOVE 5 PER CENT, AS OCCURRED FOR SEVERAL MONTHS DURING 1989.

MONETARY POLICY AND INTEREST RATES

6. THE FEDERAL RESERVE MONETARY POLICY COMMITTEE (FOMC) MET ON 27 MARCH AND APPEAR TO HAVE OPTED TO CONTINUE TO HOLD THE COST OF BANK RESERVES (THE FEDERAL FUNDS RATE) AT CLOSE TO 8.25 PER CENT. IT IS NOW MORE THAN 3 MONTHS SINCE THE LAST INTEREST RATE ADJUSTMENT, A 25 BASIS POINT REDUCTION ADOPTED JUST BEFORE CHRISTMAS. THE FED ARE NOW WIDELY VIEWED AS UNLIKELY TO EASE AGAIN IN THE NEAR FUTURE UNLESS INDICATORS SUGGEST THE REAL RISK OF A RECESSION. ON CURRENT EVIDENCE, THIS SEEMS UNLIKELY THOUGH THE MIXED SIGNALS FROM RECENT INDICATORS ARE CONSISTENT WITH A WIDER THAN USUAL RANGE OF ECONOMIC INTERPRETATIONS.

7. ANALYSTS HAVE THUS SHIFTED THEIR ATTENTION TO THE LIKELIHOOD OF HIGHER SHORT RATES AND THE PROSPECTS FOR LONG RATES. AS YET, FEW EXPECT THE FED TO TIGHTEN IN THE NEAR TERM, PARTICULARLY GIVEN THE STRENGTH OF THE DOLLAR AGAINST THE YEN. FOR LONG RATES, ANALYSIS FOCUSES ON THE OUTLOOK FOR INFLATION, AND HERE EXPECTATIONS BALANCE EVENLY BETWEEN THOSE EXPECTING A RISE AND A FALL.

8. MONEY SUPPLY GROWTH, MEASURED BY THE CURRENTLY MOST RELIABLE M2 SERIES, HAS MOVED INTO THE TOP OF THE FED'S 3 TO 7 PER CENT TARGET RANGE. OVER THE YEAR TO FEBRUARY, M2 GREW BY 5.8 PER CENT, AND OVER THE PAST SIX MONTHS HAS GROWN AT AN ANNUALISED 7.1 PER CENT RATE.

TRADE AND EXCHANGE RATES

9. THE JANUARY MERCHANDISE TRADE DEFICIT CAME IN AT 9.3 BILLION DOLLARS, ALMOST 2 BILLION DOLLARS HIGHER THAN THE ERRATICALLY LOW DECEMBER OUTTURN. AFTER ALLOWING FOR VOLATILITY IN THIS SERIES IT APPEARS THAT THE TRADE DEFICIT HAS BEEN AT BEST FLAT SINCE EARLY 1989. IN LIGHT OF THIS IT IS REVEALING THAT THE US TREASURY, IN THEIR ANNUAL TRADE REPORT TO CONGRESS, ESTIMATE THAT WHILE THE US TRADE AND CURRENT ACCOUNT DEFICITS COULD QUOTE IMPROVE FURTHER UNQUOTE BETWEEN 1990 AND 1991 THE IMPROVEMENT IS NOT LIKELY TO BE AS LARGE AS BETWEEN 1988 AND 1989 (14 AND 21 BILLION DOLLARS RESPECTIVELY). INDEED, TREASURY ADMIT THAT QUOTE THE PROSPECT OF NOMINAL DEFICIT INCREASES CANNOT BE RULED OUT UNQUOTE.

10. EXCHANGE MARKET DEVELOPMENTS IN MARCH WERE DOMINATED BY THE DECLINE OF THE YEN AGAINST THE DOLLAR. WHILE THE DMARK-DOLLAR RATE HAS REMAINED CLOSE TO 1.70 SINCE THE START OF THE YEAR, THE YEN-DOLLAR RATE HAS RISEN FROM AROUND 144 AT END-JANUARY TO 149 AT END-FEBRUARY, AND TO AROUND 158 BY END-MARCH. THE DOLLAR APPRECIATED AGAINST A WEAKER STERLING DURING MARCH, ENDING THE MONTH AT AROUND 1.65, AN APPRECIATION OF ALMOST 2 PER CENT.

FISCAL POLICY

11. THE US ADMINISTRATION HAVE RAISED THEIR QUOTE BASELINE UNQUOTE ESTIMATE OF THE FISCAL YEAR 1991 (FY91) BUDGET DEFICIT FROM 101 BILLION DOLLARS TO A RANGE OF 107 TO 115 BILLION DOLLARS, REQUIRING A MINIMUM OF 41 BILLION DOLLARS DEFICIT

REDUCTION TO ACHIEVE THE GRAMM-RUDMAN (GRH) TARGET. THE CBO, BY CONTRAST, PROJECT A 161 BILLION DOLLAR BASELINE DEFICIT, ALMOST 10 BILLION DOLLARS ABOVE THE OUTTURN FOR FY89 AND 97 BILLION DOLLARS ABOVE THE GRH TARGET.

12. THE GROWING SCALE OF FISCAL TIGHTENING REQUIRED BY CURRENT (GRH) LEGISLATION APPEARS TO HAVE ERODED THE ADMINISTRATION'S WILLINGNESS TO ACCEPT A PROGRAMME SEQUESTER SHOULD NORMAL BUDGETARY PROCEDURES FAIL TO DELIVER ADEQUATE SAVINGS. MANY SUSPECT THAT THE ADMINISTRATION, AND MOST NOTABLY THE PRESIDENT, MAY NOW BE WILLING TO NEGOTIATE A BUDGET PACKAGE WHICH INCLUDES TAX INCREASES. NEGOTIATIONS ARE AT AN EARLY STAGE AND GIVEN POLITICAL CONSTRAINTS WILL NOT PROVE EASY. EVEN IF A PACKAGE IS CONCOCTED IT IS LIKELY TO LEAVE THE FY91 DEFICIT OUTTURN IN EXCESS OF 100 BILLION DOLLARS.

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MY TELNO 279: US MONETARY POLICY
SUMMARY

1. COUNCIL OF ECONOMIC ADVISERS, FED PRESIDENTS AND THE BOND MARKETS THEMSELVES ADD FURTHER CONTRIBUTIONS TO THE DEBATE ABOUT INFLATION, GROWTH AND INTEREST RATES.

DETAIL

2. IN THEIR ANNUAL REPORT, AND IN TESTIMONY TO CONGRESS, THE COUNCIL OF ECONOMIC ADVISERS HAVE REPEATED THE ADMINISTRATION VIEW THAT THE FED COULD AND SHOULD ALLOW INTEREST RATES TO FALL. THE ANNUAL REPORT IS A WELL WRITTEN ACCOUNT OF THE ADMINISTRATION'S APPROACH TO DOMESTIC AND INTERNATIONAL ECONOMIC POLICY (COPIES BY BAG TO BROADBENT, MELLIS (TREASURY) AND GREEN (BANK)).

3. IN THE MACROECONOMIC POLICY SECTION, THE REPORT STATES THE OVERALL OBJECTIVE TO BE THE MAXIMUM SUSTAINABLE RATE OF GROWTH. FOR THIS TO BE POSSIBLE POLICY MUST BE DIRECTED AT QUOTE PREDICTABLY CONTROLLING INFLATION UNQUOTE. A CLEAR CONTRAST IS DRAWN BETWEEN THE FED, WHO WANT STABLE PRICES, AND THE ADMINISTRATION WHICH WOULD BE SATISFIED WITH A LOW (NON ZERO) BUT STABLE RATE OF INFLATION. THIS IS IN LINE WITH THE VIEW TREASURY SECRETARY BRADY EXPRESSED (SEE MY TUR) THAT A REASONABLY LOW AND STABLE RATE OF INFLATION WAS ACCEPTABLE, AND HENCE IMPLICITLY SAYING THAT THE FED'S STABLE PRICES OBJECTIVE IS UNNECESSARY.

4. THE REPORT PURSUES THIS THEME IN ITS COMMENTS ON THE DESIGN OF MONETARY POLICY AND THE OUTLOOK FOR 1990. POINTING OUT THAT THE PRESENT SLOW DOWN WAS THE LAGGED EFFECT OF TIGHT MONEY IN EARLY 1989, THE REPORT PREDICTS THAT THE EFFECT OF SUBSEQUENT EASING, AND THE FURTHER EASING THE ADMINISTRATION EXPECTS, WOULD BRING ABOUT A REBOUND. LOWER INTEREST RATES ARE NECESSARY TO ACHIEVE THE INCREASE IN HOUSING INVESTMENT WHICH IS ASSUMED IN THE REPORT TO ACCOUNT FOR A SUBSTANTIAL PART OF THE REBOUND.

5. THE REPORT ADDS THAT ALTHOUGH MONETARY AGGREGATES, ESPECIALLY M2, SHOW A GOOD LONG RUN CORRELATION WITH INFLATION, SHORT RUN REDUCTIONS IN VELOCITY ARE PRESENTLY EVIDENT AND M2

COULD EXCEED ITS 1990 TARGET. JUST TO UNDERLINE THE POINT, THE REPORT MAKES THE GENERAL OBSERVATION THAT, QUOTE EXCESSIVELY TIGHT POLICIES, WHERE DEMAND IS ALREADY WEAK AND RISING INFLATION IS NOT A THREAT CAN ALSO LEAD DIRECTLY TO RECESSION UNQUOTE. EMPHASISING THIS POINT, CEA CHAIRMAN BOSKIN TOLD THE JOINT ECONOMIC COMMITTEE THAT IN HIS VIEW THERE WAS NOW ROOM FOR A REDUCTION IN INTEREST RATES.

6. FOUR PRESIDENTS OF FEDERAL RESERVE BANKS (BLACK - RICHMOND, HOSKINS - CLEVELAND, PARRY - SAN FRANCISCO, AND CORRIGAN - NEW YORK) ALL GAVE TESTIMONY ON REP. STEPHEN NEAL'S BILL TO COMMIT THE FED TO ZERO INFLATION IN 5 YEARS. AS MEMBERS OF THE FEDERAL OPEN MARKET COMMITTEE (MEETING ON 7 AND 8 FEBRUARY) THEY WOULD NOT COMMENT DIRECTLY ON INTEREST RATES, BUT ALL ENDORSED THE OBJECTIVE OF ZERO INFLATION. CORRIGAN ADDS THE GLOSS THAT STABLE PRICES MEAN A LEVEL OF INFLATION SO LOW AS TO BE INSIGNIFICANT IN ECONOMIC DECISION MAKING (I.E. PLUS OR MINUS 1 PER CENT P.A.). BUT TOGETHER, THESE 4 WITNESSES EMPHASISED THAT THEY SHARE THE VIEW THAT THE PRESENT RATE OF INFLATION IS UNACCEPTABLE. THE ADMINISTRATION HAS NOT SUPPORTED THE NEAL BILL.

7. WHILE THESE DEBATES WERE CONTINUING, THE BOND MARKETS WERE REACTING TO A TREASURY AUCTION OF THREE-YEAR, TEN-YEAR AND THIRTY-YEAR BONDS. THERE HAD BEEN SOME NERVOUSNESS ABOUT THIS AUCTION FOLLOWING THE WEAK RESPONSE TO THE REFCORP 40-YEAR BONDS (RAISING MONEY TO PAY FOR THE THRIFT BAIL-OUT). IN THE EVENT, DEMAND FOR 3 AND 10-YEAR BONDS WAS STRONG AND THAT FOR 30-YEAR BONDS FAIRLY WEAK. BUT IN EACH CASE, THE YIELDS WERE HALF A PERCENTAGE POINT UP ON THE LAST AUCTION IN NOVEMBER.

8. FED STAFF BELIEVE THAT THESE INCREASES IN MEDIUM AND LONG-TERM INTEREST RATES REFLECT TWO FACTORS. FIRST THERE IS A PERCEPTION THAT THE FED IS NOT GOING TO EASE RATES IN THE NEAR TERM. SECONDLY, THERE HAS BEEN AN INCREASE IN INFLATIONARY EXPECTATIONS. OTHERS ATTRIBUTE THE INCREASE TO CORRESPONDING INCREASES IN JAPAN AND GERMANY.

COMMENT

9. THE PUBLIC DEBATE ABOUT SHORT-TERM INTEREST RATES SEEMS LIKELY TO FADE SOMEWHAT. THE ADMINISTRATION HAS MADE ITS POINT, AND WILL PROBABLY NOT WISH TO PROLONG THE PUBLIC BICKERING. IN ANY CASE, THE FED'S BELIEF THAT THERE HAS BEEN AN INCREASE IN INFLATIONARY EXPECTATIONS WILL NOT MAKE THEM ANXIOUS TO EASE MONETARY CONDITIONS IN THE NEAR TERM. FED GOVERNORS WILL ALSO BE MORE CONSTRAINED IN THE PERIOD BETWEEN THIS WEEK'S FEDERAL OPEN MARKET COMMITTEE, AND THE SIX MONTHLY MONETARY REPORT TO CONGRESS BY GREENSPAN ON 20 FEBRUARY.

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